

**AUDITOR LIABILITY TO THIRD
PARTIES IN SPAIN
AND THE UNITED STATES:
A
COMPARATIVE STUDY**

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DOCTOR OF LAWS**

NOVEMBER 2015

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**AUDITOR LIABILITY TO THIRD PARTIES IN SPAIN AND THE
UNITED STATES: A COMPARATIVE STUDY**

BY

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**A THESIS SUBMITTED TO THE FACULTY OF LAW,
PABLO OLAVIDE UNIVERSITY IN PARTIAL FULFILMENT OF
THE REQUIREMENTS FOR THE DEGREE OF**

DOCTOR OF LAWS

NOVEMBER 2015

DEDICATION

To the memory of my parents, Aisha Isaku Injin and Mallam Abdussamad Habibullah, this work is lovingly dedicated.

ACKNOWLEDGEMENTS

First, I thank Allah for giving me the strength and endurance to finish this project. My profound gratitude also goes to my supervisor, Dr. Francisco Oliva Blázquez for his guidance and the wealth of experience I have drawn from. I am also grateful to late Dr. Rosario Valpuesta for her kind words and encouragement. May she rest in peace! Finally, to my wife, Aisha Vasquez Vega and the members of my extended family I owe them all a debt of gratitude for their love and support.

ABSTRACT

In the aftermath of the litany of corporate scandals, few subjects have aroused so much passion in the world of accountancy as that of auditor's liability. Now the study and understanding auditors' liability to third parties cross nationally is not only fashionable but also a business imperative given the globalization of capital, corporations, and audit practice. This study explores the doctrinal differences in third party liability claims by comparing the status of auditors' liability to third parties under the common laws of the United States and the civil law of Spain. It will examine how the common and civil law courts faced with auditor liability claims, had to strike a balance between two potentially conflicting interests: the public's interest in having an independent and competent review of financial statements and the interest the auditing profession has in carrying out its duties without the fear of a potentially overwhelming liability. Specifically, it looks at the efforts of both courts to fashion out an appropriate doctrine of liability in their respective systems. Moreover, in response these scandals, the US had quickly promulgated the Sarbanes-Oxley Act to impose some restrictions on the auditor. The EU, on the other hand, in a clear response to the financial crisis has just published Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public interest entities and repealing Commission Decision 2005/909/EC, to reinforce auditor independence and improve the public supervision of audit. If anything, these scandals have taught us that even in free markets controls are necessary. Spain had from the onset embraced public supervision of auditors exercised by the *Instituto de Contabilidad y Auditoria de Cuentas* (ICAC), albeit, in collaboration with auditing professional organizations. In playing its supervision role, the ICAC was widely criticized by the members of the audit profession who then preferred the Anglo-Saxon model of self-regulation. Now the Spanish model has been vindicated and independent public oversight function is generally being embraced as the most reliable system for enhancing audit quality and market security.

RESUMEN

Después de los numerosos escándalos corporativos que hemos visto pocos temas han suscitado tanto pasión en el mundo de contabilidad como la responsabilidad civil del auditor. Hoy en día, el estudio y conocimiento transfronterizo de la responsabilidad civil de los auditores de cuentas frente al tercero no es cuestión de gustos sino una exigencia para los negocios dado la globalización de capital, corporaciones y la práctica de la auditoría. Este estudio explora las diferencias doctrinales que existen en casos de responsabilidad civil extra-contractual haciendo una comparación del estatus de la responsabilidad civil de los auditores de cuentas frente a terceros entre EE.UU y España, y hará una indagación de cómo los tribunales de “civil law” y los de “common law” que hacen frente a las reclamaciones de la responsabilidad civil extra-contractual contra los auditores, tienen que luchar entre dos intereses opuestos: el interés del público a la revisión independiente y competente de informaciones financieras y el interés de la profesión de la auditoría en realizar su función sin tener que preocuparse de la carga de una responsabilidad potencialmente aplastante. Examinará, por ello, los esfuerzos de los tribunales para crear una apropiada doctrina de la responsabilidad civil extra-contractual en ambos sistemas.

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LIST OF ABBREVIATIONS

AECA	Asociación Española de Contabilidad y Administración de Empresas
AICPA	American Institute of Certified Public Accountants
Art.	Article
ASB	Auditing Standards Board
BOE	Boletín Oficial del Estado
CC	Código Civil
CEO	Chief Executive Officer
CPA	Certified Public Accountant
DCFR	Draft Common Frame of Reference
Ed.	Edition
EC	European Community
EU	European Union
FASB	Financial Accounting services Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Accounting Standards
ICAC	Instituto de Contabilidad y Auditoría de Cuentas
Id.	Ibidem
IFRS	International Financial Reporting Standards
ISA	Independent Standard on Auditing
ISB	Independent Standard Board
LAC	Ley de Auditoría de Cuentas
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
PECL	Principles of European Contract Law
PETL	Principles of European Tort Law
RAC	Reglamento de la Ley de Auditoría de Cuentas
REA	Registro de Economistas
POB	Public Oversight Board
SAP	Sentencia Audiencia Provincial
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act, 2002
SPE	Special Purposes Entity
STS	Sentencia del Tribunal Supremo
t.	tomo
US/USA	United States of America
Vol.	Volume

1. INTRODUCTION

Societal changes have affected auditor's liability through time, and third party liability in particular has undergone significant changes in the course of the last century. The new method of raising capital through the financial markets has elevated the importance of audit functions in the global market. The auditing industry has also developed into a sophisticated global network of firms, with auditors providing a wide range of both audit and non-audit services. A diversity that has also exposed them to a greater risk of liability:

The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of the shareholders and potential shareholders.¹

Over time, audit reports had become invaluable instruments to measure stability and to provide assurance. Shareholders rely largely on the audited or verified reports of companies for reliable financial information on the state of affairs of their investment. Investors and creditors likewise are attracted to the company based on its financial stability, which is certified by the audit. Indeed, third parties confronted with insolvency of the company in which they have invested, increasingly seek to recover their economic loss from auditors who were negligent in auditing the company in question. Accordingly, the study of the liability of auditors towards third parties has grown in importance,² and has attracted enormous scholarship in the field of comparative law.

¹ See the dictum of Mr. Justice Dickson in *Haig v. Bamford* (1977) 1 S.C.R. 466 at 475-76, 72 D.L.R. (3d), 68 at 74.

² KHOURY, L., "The liability of auditors beyond their clients: A comparative study", *McGill Law Journal*, 46, 2001, p. 416, accessed August 9, 2009 at <http://lawjournal.mcgill.ca/userfiles/other/7175939-Khoury.pdf>.

Moreover, the response to the current unceasing economic crisis provoked by numerous corporate failures, partly blamed on the audit profession, has ushered in a new regulatory era globally as countries revise their legislation, regulation and case law to increase auditors' liability to third parties.³ The amount of these new regulations creates a challenge to keep track of this development and a business imperative to understand the legal climate beyond the traditional state boundaries.

Chapter I has served to give a general outlook at auditing in the wider context of corporate governance. It starts with historical background to the rise of modern companies and the figure of a director, to modernization of corporate law across the member states of the European Union, like Spain. It analysis how the emergence of directors gave birth to position auditor as a neutral third party who certifies the accounts prepared by the director. This chapter will outline the role of the director as first bastion of corporate security and how the auditor compliments that by giving the outside investor the necessary assurance as to veracity and fairness of those accounts. This is achieved by means of clear cut rules and standards that the auditor is bound to follow in order to avoid complicity and liability. These duties are examined in accordance with Spanish and United States laws.

Chapter II will attempt to provide an insight into the phenomenon of audit expectation gap, an apparent misconception between auditors and the public about the role and function of auditors in the message conveyed by the audit report. How the auditing profession viewed the problem of audit expectation gap? This misconception has been inextricably linked with the rise of liability litigation against auditors. This chapter reviews the literature on the audit expectation gap by examining its definition, nature and structure as well as factors responsible for its rise. The chapter goes on to look at the practical ways to reduce the expectation gap.

Chapter III is divided into two parts. The first part examines notion of economic loss as the precursor to the auditor's third party liability. It looks at the economic loss problem under the law of tort. How it relates with contract. Why physical loss does

³ TODA, M., & MCCARTY, W. (2005) cited in CHUNG, J., FARRAR, J. PURI, P & THORNE, L., "Auditor liability to third parties after Sarbanes-Oxley: An international comparison of regulatory and legal reforms", *Journal of International Accounting, Auditing and Taxation* 19, 2010, p. 66.

enjoy more protection than economic loss? Why was there divergence of treatment for economic loss within and across systems? The courts' reluctance to allow recovery not linked with physical loss or injury for the fear that such admission would open the door to a mass of litigation which might very well overwhelm the courts. The mutual concerns of both common and civil law courts to keep liability exposure on check and their use of duty in case of common law and causation for civil law to achieve that. Attention is also given to the uncertainty regarding the prerequisites for compensation of economic loss and the lack of consistent framework in determining recoverability. The chapter concludes with an opinion on the ongoing debate over the propriety of recovery expansion or otherwise.

The second part provides a detailed look at auditor's liability towards third parties. It examines the evolution of third party liability in the United States common law and the legal reasoning and the social jurisprudence the courts had employed to bring it about. As audit liability under the common law is a matter of state law in the United States, and a split exists among the states as to the individuals to whom the auditor owes a duty of care, a review of the legal doctrines that underpin auditor liability to third parties and the intellectual framework the courts have established to determine liability one way or the other, would also be undertaken. The remainder of this chapter discusses Spanish civil law approach to the auditor liability to third parties. Although audit liability is compensated under the general principle of liability, as long as it meets the conditions of directness, legitimacy, and certainty set out in the codes, recovery is however, restricted by the courts through the use of causation. The concern of indeterminate liability the civil law shares with the common law will also be highlighted. Ultimately, a cursory look at the similarity of roles duty and causation play to limit liability.

Chapter IV highlights the change in audit regulatory framework of United States and the European Union provoked by the chain of corporate scandals across the Atlantic, epitomized by the Enron. It starts with history of corporations together with rise of the financial markets. It goes on to examine the earlier debates regarding the adequacy of peer review and self-regulation of the auditing profession together with the atmosphere of greed that failed to foresee or prevent the corporate scandals. These scandals were the final straw that moved authorities in the United States and Europe to act. That was the history of both the Sarbanes-Oxley Act and the 8th Directive.

Chapter V will appraise the judicial changes in tort rules in the US and how the expansion in third party liability was received by the accounting profession. Indeed some tort liability judgments have rendered some firms insolvent. The audit industry in the US perceiving themselves as beleaguered victims of a capricious and irrational tort system, called for tort reform.⁴ But can the same be said of Spain? Where despite the system of general responsibility it maintains, third party liability against auditors is of rare occurrence until recently. The chapter also examines the global reach of the litigation liability campaign of auditors, their successes as well as their challenges.

Finally, this study contributes to the auditor liability debate. It is hoped that it enhances understanding of the cultural and legal environment that underpin the differences between liability regimes of the US and Spain.

⁴ SILICIANO, A. J., "Negligent Accounting and the Limits of Instrumental Tort Reform" *Michigan Law Review* 86, 1988, p. 339.

CHAPTER I

AUDITING IN THE CORPORATE LAWS OF THE UNITED STATES AND SPAIN

1. INTRODUCTION

This chapter is intended as a foundation for understanding auditor's⁵ liability to third parties,⁶ but audit can hardly be discussed in the absence of an annual report which will in turn lead to corporate governance.⁷ The chapter therefore looks at a number of contextual issues regarding corporate governance. It analyzes the position of the company director as the first reference of responsibility under the Sarbanes-Oxley Act as well as Spanish corporate law.⁸ It also looks at the function of an audit and outlines the general role and responsibilities of auditors. It is however, difficult and even dangerous to analyze auditor's responsibility outside the context of auditor's wider role in the corporate governance system. That being the case, perhaps, the logical starting point is to appraise the phenomenal evolution of the audit accounting profession from a mere bookkeeping to a major player in the modern day corporations.⁹ This without a doubt is owed to the growth in importance of the financial statement which has become a veritable instrument used by corporations to attract capital.¹⁰ As the use of financial statements became widespread among companies not run by their owners, audit became an instrument of reassurance to persons who have a financial interest in companies, aside from the company's directors. Thus in ensuring company's viability and investor protection, there is no better method than accountability in the companies through open disclosure by the board of directors followed by a thorough audit carried out in accordance with strict accounting standards.

⁵ Auditor, "Auditor de Cuentas", accountant, public accountant, and Certified Public Accountant as used in this treatise will refer to a Certified Public Accountant in public practice.

⁶ Third parties as used herein refer to any investors who rely on the financial statements and any creditors of the business entity.

⁷ Corporate governance is simply, a role assigned to person of directing and control of a corporation.

⁸ Director, board of directors and management will be used interchangeably in this thesis.

⁹ KHOURY, L., Liability of Auditors..., op. cit., p. 416.

¹⁰ COOKSON, C. R., "The Delictual Liability of Auditors to Third Parties for Negligent Misstatements", *Cilsa* X, 1977, p. 5, accessed April 4, 2012 at http://reference.sabinet.co.za/webx/access/journal_archive/00104051/1043.pdf

2. THE BIRTH OF AUDIT IN THE UNITED STATES

For many centuries, most business organizations were small in size and run by their owners.¹¹ These small and mostly family owned business organizations in Europe were known to maintain some system of bookkeeping. According to RAMAMOORTI, “within a span of a couple of centuries” the system of bookkeeping used by these European businesses found their way into the United States.¹² Because the businesses were run by their owners, there was no necessity to give accounts to outside parties. The industrial revolutions however paved the way for the growth and expansion of these once small business enterprises into large corporations.¹³ As these corporations grew in size and needed to expand to new markets or finance expensive project, there arose the need to raise capital in order to fund this expansion.¹⁴ With their expansion and increase in complexity the need for professional directors¹⁵ also became necessary, which gave rise to separation of management and ownership.¹⁶ This development was brilliantly described by QUEENAN as follows:

The economic system, after having progressed at a relatively slow pace for centuries has been revolutionized by the advancement in technology and by changes in the industrial organizations and government activities. Many enterprises have come to rely on external capital and credit which has separated ownership from management. These developments have had a vital impact on the economy of the free world and on the progress of our profession. Accounting has become increasingly important for internal administration and control and for external financial reporting. In countries with a highly developed industry . . . the accounting profession has progressed from a small group of practitioners

¹¹ RAMAMOORTI, S., *Internal Auditing: History, Evolution, and Prospects*, The Institute of Internal Auditors Research Foundation, Altamonte Springs, Florida, 2003, p. 3, accessed July 14, 2012 at: <https://na.theiia.org/iiarf/Public%20Documents/Chapter%201%20Internal%20Auditing%20History%20Evolution%20and%20Prospects.pdf>.

¹² Id.

¹³ BAXT, R., “The Liability of Accountants and Auditors for Negligent Statements in Company Accounts”, *Modern Law Review* 36, 1973, p. 42, accessed June 15, 2013 at http://reference.sabinet.co.za/webx/access/journal_archive/00104051/1043.pdf.

¹⁴ RAMAMOORTI, S., *Internal Auditing*..., op. cit., p. 3.

¹⁵ The term “director” has been defined by section 3 of the Securities and Exchange Act of 1934 (hereinafter “SEC”) to mean “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.”

¹⁶ COOKSON, C. R., *Delictual Liability*..., op. cit., p. 5.

concentrated in a few centers of population and unrecognized publicly, to a well organized profession enjoying worldwide influence.¹⁷

Thus, the growth of the modern corporation does not only give birth to the separation between ownership and management but also the prevalence of owners who do not directly run their businesses.¹⁸ These diverse groups of owners usually hire professional directors for the day to day running of the business, which gave rise to the concept of corporate governance, the way companies are organized and controlled. Although corporate governance is as old as company itself, the concept became popularized in the latter part of the 20th century.¹⁹

3. MODERNIZATION OF CORPORATE LAWS IN SPAIN

It is trite that the evolution of financial accounting and auditing in any society is closely linked with the economic activities undertaken by such a society. Spain is not an exception. Corporate law in Spain can be traced back to the Commercial Code of 1885, where the drafters of the code under article 32 contemplated some accounting procedures among the then small business enterprises without making it obligatory.²⁰ Other Spanish laws like “Ley de 17 de junio de 1951”,²¹ “Decreto Ley 7/64, de 30 abril de 1964”,²² also made mention of accounting or audit. However, obligatory audit was not contemplated in Spain until 1973 when the Commercial Code was modified by Ley de 21 de Julio de 1973.²³

This law was significant in the transformation of Spain’s accounting profession because it did not only recognize the need for expertise in audit but it also symbolized the

¹⁷ QUEENAN, J. W., in an address to the Third Congress of Chartered Accountants of South Africa on April 25, 1966 quoted from ANDERSON, A. P., “Accountants’ Liability to Third Parties for an Audit”, *Marquette Law Review*, 52, 1968, p. 162.

¹⁸ The growing need for external funding by businesses gave way for diverse group of persons interested in the business, these according to KHOURY, included “prospective purchasers of shares, potential investors, banks, suppliers, sureties, lenders, and public authorities...” KHOURY, L., *Liability of Auditors...*, op. cit., p. 418.

¹⁹ MONGALO, T., “The Emergence of Corporate Governance as a Fundamental Research Topic in South Africa”, *South African Law Journal*, 2003, p. 185.

²⁰ Article 25 “Real Decreto de 22 de agosto de 1885, por el que se publica el Código de Comercio” (hereinafter ‘CCOM’).

²¹ Ley de 17 de junio de 1951 de régimen Jurídico de las Sociedades Anónimas (hereinafter “LSA”).

²² This law was on housing and capital markets.

²³ Other laws in this category included: Ley 46/1984, Real Decreto Ley 710/1986 de 4 de abril and Ley 3/1987, de 2 de abril, Ley 22/87, de 11 de noviembre, among others. Generally, see PACHECO CAÑETE, M., *Régimen Legal de la Auditoría de Cuentas y Responsabilidad de los Auditores*, CES, Madrid, 2000, pp. 24-27.

subsequent transition from internal to external audit. However, the most important leap yet on audit accounting in Spain came by way of a Directive from the European Union at the time of Spain's accession into the union.²⁴

The European Union, on the other hand, pursuant to its single financial market goal, has been transforming company laws of member states to bring them into harmony in an effort to create a regional legal framework for auditors as outlined in the Financial Services Action Plan.²⁵ This is done through the medium of directives. Accordingly, audit and company laws in member states are based on the Directives coming from the European Council, particularly, Directive 2006/43/EC on the Statutory Audits of Annual Accounts and Consolidated Accounts, also known as The 8th Company Law Directive. The Directive which came into force on 29 June 2006 was implemented by member states by the end of June 2008. The Directive amended and expanded the 8th Council Directive of the 10th April 1984 on the approval of statutory auditors in EU member states. Principally, “the Directive sets out the duties of statutory auditors and audit firms and introduced a requirement for public oversight of the audit profession and co-operation between regulatory authorities in the EU” member states.²⁶ Other notable legal texts accompanying this Directive are the Accounting Directive 2013/34/EU, the Transparency Directive 2004/109/EC and the Solvency II Directive 2009/138/EC. These legal instruments have, among other things, made audit of certain companies obligatory and addressed the specific needs of public-interest entities, as defined by the Accounting Directive, i.e. financial institutions or listed companies.

The above framework has just been further revised by two enabling legal instruments, to wit, “Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public interest entities and repealing Commission Decision 2005/909/EC.” The

²⁴ Accession into the European came as a result of several years of intense negotiations and fulfillment of some principal legal, democratic and human rights conditions. The Spanish corporate law was a beneficiary of this requirement.

²⁵ Financial Services: Implementing The Framework for Financial Markets: Action Plan, adopted by the European Commission on May 11, 1999, COM (1999) 232, 11.05.99, accessed June 5, 2010 at http://ec.europa.eu/internal_market/finances/docs/actionplan/forumgroups/manipulation1_en.pdf.

²⁶ Directive 2006/43/EC.

overall objective of this reform is to provide stricter rules of engagement for audit of public-interest entities, strengthen the powers of public authorities responsible for audit oversight as well as restoring public confidence in the financial markets after the recent financial crisis. Member states must implement the Directive on or before the deadline of 16 June 2016, which is also the date of direct application of the Regulation, the first of its kind to apply to statutory audit. Spain has already implemented this Directive by incorporating its provisions into the new Audit Law, “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas.”²⁷

Most of Spanish commercial and company laws are shaped by the requirements of these Directives including the Audit Law. Accordingly, modern Spanish corporate law is founded on a number of important legislations which were adapted from the European Union Directives. Chief among these are the Commercial Code, Company Law, Securities Markets Law and the Audit Law together with rules and regulations made under them.

Evidently, the immediate essence of corporate governance is to benefit the shareholders of the company but its ultimate objective is to efficiently allocate capital for its most productive use. This responsibility is principally entrusted with the director. Consequently, directors are responsible for the company’s financial statement as well as its internal control structure. In other words, they are the first bastion of corporate governance. Therefore, it would be unrealistic to imagine any effective check or a proper audit, for that matter, without the director’s close collaboration.

4. THE POSITION OF DIRECTOR IN CORPORATE GOVERNANCE

The position of director is a sine qua non requirement under all company laws. Since company law is traditionally under states, not federal jurisdiction in the United States, this provision is found under various States’ statutes.²⁸ Incidentally, many of these statutes are modeled after the Model Business Corporation Act.²⁹ Accordingly,

²⁷ “Real Decreto Legislativo 1/2011, de 1 de julio, por el que se aprueba el texto refundido de la Ley de Auditoría de Cuentas” is still the law in force in Spain. The 2015 Audit Law, which derogates this law, will enter into force on 17 June 2016. All reference to Spanish audit law in this thesis shall be to the 2015 Audit Law, “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas” (hereinafter called “LAC”).

²⁸ The federal government does not have a statute under which a company can be validly incorporated.

²⁹ The Model Business Corporation Act (MBCA), according to Wikipedia, is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association

following the MBCA many states statutes required for director's appointment by providing that the business and affairs of corporations shall be managed by or under the direction of a board of directors.³⁰ A similar provision is found under article 209 of the Spanish company law where management and control of company affairs are assigned to the directors of the company.³¹

4.1 THE STANDARD OF DIRECTOR'S CONDUCT IN THE UNITED STATES

Directors are appointed under contract by the shareholders at a general meeting. By accepting their appointment, directors are obliged to perform their duties to a certain standard, which is held at common law to be fiduciary.³² It follows that in the United States the concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago.³³ A concept that never stops evolving. It is trite that at common law the frontier of duty is never closed. Nonetheless, fiduciary duties of directors are also statutorily provided for under state laws. For example under section 8.30 of the MBCA, fiduciary duty of directors has been characterized as including duties of good faith, due care and

and is now followed by majority of states in the United States. Please see Wikipedia, accessed August 7, 2013 at http://en.wikipedia.org/wiki/Model_Business_Corporation_Act.

³⁰ See MBCA Section 8.01 (2002).

³¹ "Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital" as amended by "Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo" (hereinafter "LSC"). The said article 209 provides "es competencia de los administradores la gestión y la representación de la sociedad en los términos establecidos en esta ley." Article 210 LSC, on the other hand, provides for the manner in which to organize company management, thus "la administración de la sociedad se podrá confiar a un administrador único, a varios administradores que actúen de forma solidaria o de forma conjunta o a un consejo de administración."

³² It is a settled law that relationship between directors and a company is that of fiduciary. A fiduciary duty, on the other hand, is considered by law to be the highest degree of care and loyalty, meaning that the director must act with utmost good faith and always in the best interest of the company. Fiduciary duty is generally owed to the company and its shareholders, but when a company is on a brink of bankruptcy this may extend to creditors as well. EGAN, B. F., *Director Fiduciary Duties under Delaware and Texas Law*, paper presented at the 31st Annual Conference on Securities Regulation and Business Law, Dallas, Texas, February 13, 2009, p. 1, accessed November 7, 2013 at <http://images.jw.com/com/publications/1106.pdf>. Please see also *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, where JUSTICE CARDOZO held that fiduciary relationship requires "not honesty alone, but the punctilio of an honor the most sensitive." Pursuant to the independence required between accountants employed to audit a financial statement and a client, there cannot be a fiduciary relationship between the accountant and his client. In *Resolution Trust Co. v. KPMG Peat Marwick*, 844 F. Supp. 431 at 436 it was held that the level of independence required of accountants in the audit process is fundamentally inconsistent with a status of a fiduciary.

³³ EGAN, B. F., *Director Fiduciary Duty*..., op. cit., p. 2.

loyalty to the company, albeit, these duties are interpreted and applied in the same way as common law rules or equitable principles.³⁴

Company's board of directors has been "granted plenary authority over the affairs of the company, the manner in which it exercises that authority largely is left to the discretion of directors. For the most part, corporate statutes do not specify what directors are to do in directing the company affairs, or how they are to do it."³⁵ But what the law emphasizes is that such authority must be exercised in accord with director's standards of conduct as enshrined in the MBCA and the general principles of duty under common law.³⁶ However, "these duties are not generally framed as precise rules, but instead are expressed as general duties or standards," and while they may be distinctly analyzed sometimes they are component of unit called corporate governance and complement each other.³⁷ These duties are discussed below.

4.1.1 DIRECTOR'S DUTY OF CARE

The duty of care requires the director to handle the affairs of the company with such care as a prudent man of his standing would do under similar circumstances. The duty of due care requirement mainly focuses on decision-making process of the director. However, this duty only specifies the manner in which directors must discharge their legal responsibilities, not the substance of director decisions. Accordingly, in carrying out this function, the director is under obligation to be 'diligent and informed and exercise honest and unbiased business judgment in pursuit of the company's interests.'³⁸ Pursuant to their 'statutory responsibilities to direct the business and affairs of the company, directors also have a duty to properly monitor and oversee the business affairs of a company.'³⁹ This includes the responsibility to see that in working to achieve its

³⁴ Fiduciary duties of corporate officers including directors are still largely creatures of states' common law. See *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549 (1949).

³⁵ JOHNSON, L. P. Q., "The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective", *S. Tex. L. Rev.* 47 2005-2006, p. 30, accessed June 6, 2013 at <http://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=1072&context=wlufac>.

³⁶ See *Cohen v. Beneficial Industrial Loan Corp.* and MBCA Section 8.30 (2002).

³⁷ JOHNSON, L. P. Q., *State Law Perspective...*, op. cit., p. 34. For example, the application of the duties of care, loyalty and good faith by courts has given rise to the duty of disclosure, which is not a separate duty on its own right but rather an extension of duties of care and loyalty. As demonstrated in the case of *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1280 (Del. 1994), where it was held that "Once [directors] traveled down the road of partial disclosure ... an obligation to provide the stockholders with an accurate, full, and fair characterization" is implied.

³⁸ EGAN, B. F., *Director Fiduciary Duty...*, op. cit., p. 8.

³⁹ JOHNSON, L. P. Q., *State Law Perspective...*, op. cit., p. 35.

purpose the company functions within the law.⁴⁰ Failure by the directors to properly handle this obligation may constitute a breach of the fiduciary duty of care.⁴¹ As judicially sanctioned in the seminal case of *In re Caremark Int'l Inc. Derivative Litigation* by the Delaware Court of Chancery:

A director's obligation includes a duty to attempt in good faith to assure that corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.⁴²

Moreover with the advent of the Sarbanes-Oxley Act,⁴³ directors cannot feign ignorance of what is happening under their watch. They have an obligation to take reasonable steps to detect and prevent violations of the law by their companies. This includes ensuring that the company has in place an appropriate internal "information and reporting system" designed to enable adequate oversight by directors of the company's compliance with the law and business performance.⁴⁴ As stated above these standards were required by various state statutes and imposed by courts under common law. That notwithstanding, the Sarbanes-Oxley Act 2002 was also enacted at federal level to reinforce the importance of corporate governance. According to Chancellor ALLEN, the relevance of the Sarbanes-Oxley Act is to "infuse new meaning into state law notions of

⁴⁰ Id. He must ensure that the company acts within its powers and does not go *ultra vires* i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation.

⁴¹ With the passage of the Sarbanes-Oxley Act, the SEC, pursuant to its rulemaking authority under section 404 requires internal control certification of companies to further enhance the accountability of the management. As stated by SEC Chairman William Donaldson, "...By requiring a report stating management's responsibility for internal control over financial reporting and management's assessment regarding the effectiveness of such control, investors will be better able to evaluate management's stewardship responsibilities and the reliability of a company's disclosure." See William H. Donaldson, Chairman of the U.S. Securities and Exchange Commission, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002, Before the Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2003), accessed July 1 2012 at http://www.senate.gov/~banking/_files/donaldsn.pdf.

⁴² *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

⁴³ This legislation came into force in 2002 and was hailed as the most important securities legislation since the Securities Acts of 1933 and 1934. The Act, named after Senator Paul Sarbanes and Representative Michael Oxley, introduced major changes to regulation of financial practice and corporate government in the United States

⁴⁴ Section 404 Sarbanes-Oxley Act requires the company to establish and maintain an adequate internal control structure. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003) it was held that failure to exercise proper oversight function through inaction is a breach of fiduciary duty.

“reasonable” oversight in a way that leads courts to demand greater director and committee member vigilance under the reasonableness standard of *Caremark*” case.⁴⁵

4.1.2 DIRECTOR’S DUTY OF LOYALTY

The duty of loyalty requires directors to act in the best interests of the corporation. What this means is that directors must not place themselves in a position in which their duties to the company will be in conflict with their personal interests. Accordingly, a director must refrain from usurping the powers of the company to engage in an unfair self-dealing transaction or use the company assets or confidential information for personal gain. The duty of loyalty may be both “affirmative and harm-avoidance.” As reiterated by Chancellor CHANDLER: “[T]he ‘duty of loyalty... imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that [a director] absolutely refrain from any conduct that would harm the corporation.’”⁴⁶

4.1.3 DIRECTOR’S DUTY OF GOOD FAITH

The good faith requirement has long been important to fiduciary analysis in corporate law, but its meaning has been somewhat nebulous.⁴⁷ Good faith is said to relate to the

⁴⁵JOHNSON, L. P. Q., *State Law Perspective...*, op. cit., p. 36

⁴⁶Id at p. 37 (quoting the dictum of Chancellor William CHANDLER *In re Walt Disney Co.* 825 A.2d 275 at 289 (Del. Ch. 2003)).

⁴⁷ Good faith sometimes has been held to be an element of the duty of loyalty and it is in fiduciary relationship that good faith is mostly understood in common law. See *Gearhart Industries, Inc. v. Smith Intern., Inc.*, 741 F.2d. (5th Cir. 1984). Unlike many civil law jurisdictions of the Continental Europe, common law, generally, does not imply an obligation of good faith on contractual parties. Common law courts take the view that parties should have the freedom to contract for what they wish and should be able to retract anytime before agreement. The common law position is based on the premise that parties to a contract are on opposite sides of the negotiating table, and the Latin maxim is *caveat emptor*, let the buyer beware. Generally, when a contract has been entered into there is no duty to act in good faith. However, common law has tended to operate on a case-by-case basis whereby the courts have under certain circumstance developed solutions in response to certain problems of unfairness, like in cases of contract of employment, agency, insurance and partnership.

It is noteworthy that in other common law jurisdiction like the United States, the principle of good faith is making headway, as seen in the US Commercial Code “every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement” U.C.C. ss. 1-203. Similar provisions are found in Canada and Australia. It is only English law that had resisted this intrusion and that may be changing soon.

For a long time now, it is believed that the concept of good faith may creep into English law through the influence of European law. EU member states are required to implement and transpose some legal principles like the Common European Sales Law where it was provided that each party has a duty to act in accordance with good faith and fair dealing. The change is closer to home than earlier imagined as held by Leggatt J in a recent locus classicus of *Yam Seng Pte Ltd v. International Trade Corporation Ltd* [2013] EWHC 111 that a contractual duty of good faith could be implied under the English law. The Judge went on to boldly argue that “I respectfully suggest that the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent it still persist, is misplaced.” Id.

director's conduct at a given point in time. Thus "directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision" has been held to constitute a breach of good faith.⁴⁸ Chief Justice VEASEY, on the other hand, puts it this way:

In my opinion, good faith requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the wellbeing of the constituents of the fiduciary. Although the concept of good faith is not fully developed in the case law, and factual scenarios are difficult to formulate, an argument could be made that reckless, disingenuous, irresponsible, or irrational conduct-but not necessarily self-dealing or larcenous conduct-could implicate concepts of good faith. If the board's decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.⁴⁹

The key issue in the above authorities seems to point to a question of motive of the director to be inferred from the circumstances of his decision. Thus in analyzing good faith the courts look to whether or not the director's purpose was to advance the interest of the company.⁵⁰

4.2 STANDARD OF "LOS ADMINISTRADORES" IN SPAIN

Spanish law, in line with its civil law tradition, has codified director's duties and specified them under chapter III articles 225 to 230 of the company law "LSC" as revised by "Ley 31/2014, de 3 de diciembre, por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo." These duties in their significance mirror the American position and are, inter alia, duty of reasonable care, skill and diligence, and loyalty to the company in carrying out the functions conferred

⁴⁸ See the dictum of CHANCELLOR WILLIAM CHANDLER *In re Walt Disney Co.* 825 A.2d 275at 289 (Del. Ch. 2003).

⁴⁹ VEASEY, E. N., "State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors", *J. Corp. L.* 28, 2003 at p. 447, accessed June 7 2013 at <http://www.citeulike.org/user/COKSarbox/article/380907>.

⁵⁰ JOHNSON affirms here that "deliberate indifference to the director duties of care and loyalty, or consciously disregarding those duties, is conduct sufficiently faulty to indicate a lack of the required motive- i.e., good faith-of advancing the best interests of the company," see JOHNSON, L. P. Q., *State Law Perspective...*, op. cit., pp. 38-39.

on him by the company's statutes. The director must also avoid conflict of interest and competition with the company.

4.2.1 DUTY OF DILIGENCE OF “EL ADMINISTRADOR”

The Spanish company law “LSC”, under its article 225 requires company directors to exercise their functions with due diligence and in accordance with the statutes and articles of the company. The article used the phrase “un ordenado empresario” a skilled businessman to refer to the standard required of a director. This signifies that the director is expected to use his or her particular skills, experience and knowledge for the benefit of the company. The court summarized this standard as “conducta socialmente esperable en el tráfico, integrando en gran medida los usos del comercio y las buenas prácticas de la gestión empresarial.”⁵¹ The director must take all necessary measures to ensure the good control and proper working of the company. He or she also has an obligation to seek and obtain all necessary information required to carry out his or her obligations.⁵² It has been held that denying directors' access to company's incorporation documents is inconsistent with this function. The relevant arbitral decision reads:

La combinación de las normas que regulan las facultades y deberes de los administradores sociales con las que determinan su responsabilidad en el ejercicio del cargo parecen excluir la posibilidad de una restricción como la que se contempla. Aparte de la representación corresponden al órgano de administración las facultades de gestión o administración que tienen diversas manifestaciones, en la mayoría de las cuales la consulta de la documentación social ha de considerarse como esencial a la hora de adoptar las oportunas decisiones o de ejecutar las ya adoptadas. (...) Si en relación con todas esas actuaciones los administradores han de actuar con la diligencia de un ordenado empresario (...) difícilmente puede exigírseles que se atengan a ese mandato legal si se les hurta la posibilidad de consultar la documentación social y tomar, en base a la misma, las decisiones más adecuadas.⁵³

⁵¹ SAP Navarra de 15 de febrero de 1995 (AC 1995\294).

⁵² Article 225.3 LSC. The amended article 226 incorporated the common law-derived doctrine of business judgment rule where directors are accorded the presumption of acting in *bona fide* and in the best interest of the company.

⁵³ RESOLUCIÓN de 4 de mayo de 2005, de la Dirección General de los Registros y del Notariado.

4.2.2 DUTY OF LOYALTY OF “EL ADMINISTRADOR”

On loyalty of directors, on the other hand, article 227 of the Spanish company law “LSC” stipulates that “los administradores deberán desempeñar el cargo con la lealtad de un fiel representante, obrando de buena fe y en el mejor interés de la sociedad.” This implies that directors must carry out their function with loyalty must faithfully represent the company. Directors must act within the powers conferred on them by the company’s statutes and in accordance with the law.⁵⁴ Directors are obliged to keep all company secrets at their disposition even after ceasing to be so except where permitted by law. They should also abstain from any deliberation or voting on agreements where their interest or interest of someone close to them may conflict with that of the company.⁵⁵ This presupposes that the directors must put the interest of the company ahead of their own interest, and this duty should be to the company as a whole, and not to any individual, or group of shareholders. As held in the decision of *SAP of Guipúzcoa of June 4, 1999* where the court denounced an action calculated to benefit a group of shareholders:

...todo parece indicar que esta actuación (...) obedece a la defensa de intereses particulares de un grupo de socios que tiene como finalidad la venta de la Sociedad, por lo que se trata de una operación en la que quedan postergados los intereses de la Empresa (...). Los accionistas tienen libertad para disponer de los títulos de su propiedad, pero lo que no resulta admisible es que un Consejero Delegado forme grupo de accionistas para una venta de acciones con finalidad de beneficio propio y con olvido de los intereses de los restantes socios de la compañía.⁵⁶

4.2.3 PROHIBITION OF CONFLICT OF INTEREST OF “EL ADMINISTRADOR”

One of the fundamental duties of a director under article 229 of the Spanish company law is to avoid any possible conflict of interests with the company. The law prohibits a director from using his or her position, or any information obtained while acting in that

⁵⁴ Article 228 LSC. Infraction to the duty of loyalty would lead to liability not only for the loss caused to the company’s assets but also returning any benefit obtained by the directors. See article 227.2.

⁵⁵ Article 228 LSC.

⁵⁶ SAP Guipúzcoa de 4 junio de 1999 (AC 1999\1446).

capacity for personal gain.⁵⁷ Directors must not engage in any activity by themselves or through third parties that might compete with or affect the interest of the company and must communicate any prior personal interest or of any person related to the company.⁵⁸ The director is also bound not to compete with the company, or use its assets or confidential information for personal benefit.⁵⁹ In addition, the provisions on duty of loyalty are absolute and cannot be limited or impaired by any contrary statute except in circumstances contemplated under article 230 LSC.

It is an accepted principle of Spanish law that when a director involves in an activity or a transaction similar with that of the company competition may be presumed. This principle was reiterated by the Supreme Court of Spain in its judgment *STS de 7 de noviembre 1986*. The learned Justices elucidated the position of the law as follows:

...resulta acreditado que el actor -recurrente- realizó una actividad comercial desleal y competitiva análoga a que constituía el objeto social de la compañía mercantil de la que era administrador (...) aquél incurrió en actividades comerciales del mismo género que las de la compañía mercantil citada, que le estaban prohibidas, por su condición de administrador de ésta, tanto por el Art. 12, de los Estatutos como por el también Art. 12, párrafo segundo, de la Ley de Sociedades de Responsabilidad Limitada (*de 1953*), con la consiguiente sanción de exclusión del socio desleal prevista en el Art. 31 de la misma Ley.⁶⁰

By these duties, the Spanish legislature seems to encourage the board of directors to act honestly and to promote the success of the company in the collective interest of shareholders. They are also meant to set a standard for directors in conducting the company's affairs. However, it is worthy of note that the standard applies to all directors as well as officers of the company, and no distinction is made between executive and non-executive directors. Where the company suffers a loss or damage as a result of the director's failure to comply with the above prescribed duties, the director will be personally liable under article 236 LSC.

⁵⁷ Article 229 LSC.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *STS de 7 de noviembre de 1986 (RJ 1986\6215)*.

5. THE AUDITING CONTEXT

As seen above, company directors owe several fiduciary duties to the company as well as its shareholders. Part of such duties is to maintain and prepare annual accounts of the company. Chancellor William ALLEN once noted that the monitoring and oversight obligation of directors “includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists...”⁶¹ This inevitably is the information that goes into the company’s financial statements.

5.1 THE FINANCIAL STATEMENTS

Financial information is an important fabric of modern corporate governance. It is a *sine qua non* requirement in all companies. In the United States, for example, apart from the provisions found under various states statutes with regards to annual reports, the Securities Exchange Act of 1934 in section 13 also required companies to file annual reports. This provision is to be found in the General Rules and Regulations promulgated under the Securities Exchange Act of 1934. Rule 15 (d) (1) thereof provides that unless exempted by the law, a company “shall file an annual report, on the appropriate form authorized or prescribed therefor, for the fiscal year in which the registration statement under the Securities Act of 1933 became effective and for each fiscal year thereafter...”

Companies in Spain are also required to prepare and maintain account statements in accordance with the nature of business activities they undertake. Article 253 of the Spanish company law provides:

Los administradores de la sociedad están obligados a formular, en el plazo máximo de tres meses contados a partir del cierre del ejercicio social, las cuentas anuales, el informe de gestión y la propuesta de aplicación del resultado, así como, en su caso, las cuentas y el informe de gestión consolidados.⁶²

The accounts statements must be comprised of a profit and loss and a balance sheet of the company as at the last day of the financial year. These documents are to be prepared with clarity and must give the true and fair view of the company’s net assets as well as

⁶¹ See *In re Walt Disney Co.* 825 A.2d 275(Del. Ch. 2003).

⁶² *Id.*

its financial situation in accordance with the provisions of the Spanish company and commercial laws.⁶³

5.2 PUBLICITY OF FINANCIAL STATEMENTS

For obvious reasons, managers of the company are charged with the responsibility of preparing the annual returns. Generally, managers are more informed about the true financial position and results of operations of the entity than the shareholders. Although the law requires utmost good faith from the manager, sometimes the interests of the management do not coincide with that of the shareholders. For instance, we have seen how greed by managers of renowned companies around the world had led their companies into financial catastrophes. These catastrophes have forever changed the lives of many for worse, leaving them in financial ruin with their life-savings disappearing into the thin air. Others are forced out of their homes through sale or foreclosure by their banks. Unfortunately, this is an experience shared in Spain as well as in the United States.

Be that as it may, given that shareholders are not directly involved in running the businesses they own; the financial statements are the means by which directors inform the shareholders of their stewardship. Although financial statements are primarily designed to keep shareholders informed on the economic and financial situation of the company, they also serve as a source of information to the general public.⁶⁴ In fact, the law requires that financial statements be distributed to all shareholders and must also be made public by filing it at the corporate registry. Once filed at the registry it becomes a public document and general public as well as third parties who deal with companies are presumed to avail themselves of the contents these documents. In other words, they are presumed to have constructive notice of all public documents which are open to public inspection.⁶⁵ Publicity of financial statements is also required under Spanish Securities

⁶³ Article 254 LSC.

⁶⁴ PANTTAJA, R. S., "Accountants' Duty to Third Parties: A Search for a Fair Doctrine of Liability", *Stetson Law Review* 23, 1994, 932, accessed May 6, 2012 at <http://www.stetson.edu/law/lawreview/media/accountants-duty-to-third-parties-a-search-for-a-fair-doctrine-of-liability.pdf>.

⁶⁵ COOKSON, C. R., *Delictual Liability...*, op. cit., p. 5.

Markets Law.⁶⁶ Article 241 of the LMV requires that audit report together with financial statements be made public and accessible.⁶⁷

These documents are often the only means persons dealing with the company have in knowing finances of the company.⁶⁸ As BAXT observed, a person who is about to extend a small amount of credit is not likely to ask for either the audited balance sheet, profit and loss statement, or a current set of draft accounts. In fact, the main reason for requiring companies to file these documents at the registry is to enable these persons and the general public have access to them in good time when the need to ascertain the financial position of any particular company arises.⁶⁹

This situation is succinctly described by GOWER as follows:

In these ... ways ... members and the public (which, for practical purposes, means creditors and others who may subsequently have dealings with the company and become its members or creditors) are supposed to be able to obtain the information which they need to make an intelligent appraisal of their risks, and to decide intelligently when and how to exercise the rights and remedies which the law affords them.⁷⁰

A similar opinion is pronounced by FERRÁNDIZ GABRIEL as follows:

La publicidad constituye un instrumento jurídico por medio del que se traduce un interés general difuso –no ajeno a la conveniencia de aumentar de modo efectivo la calidad de la información financiera-, en el concreto de cada uno de los terceros que entren en relación con la sociedad auditada, confiados en la

⁶⁶ “Real Decreto Legislativo 4/2015, de 23 de octubre, por el que se aprueba el texto refundido de la Ley del Mercado de Valores” [hereinafter “LMV”].

⁶⁷ The Spanish Stock Exchange is required to maintain an open registry as provided under article 238 LMV as follows: “La Comisión Nacional del Mercado de Valores mantendrá, con el carácter de registros oficiales, a los que el público tendrá libre acceso.”

⁶⁸ KHOURY, L., *Liability of Auditors...*, op. cit., p. 418.

⁶⁹ The aim of the publicity of the financial statement is to give the investing public, as much as it feasible, “the fullest practicable disclosure of information concerning the activities of companies...” see Report of the Committee on Company Law Amendment (Cohen Report) 1945 Cmd. 6659, par. 5.

⁷⁰ GOWER, L. C. B. (1969) in COOKSON, C. R., *Delictual Liability...*, op. cit., p. 5.

fiabilidad que ofrece un sistema de regulación del mercado de capitales tan sofisticado como costoso.⁷¹

Although financial statements are required to be made public, members of public who are strangers to the internal control of the company, do not have means of verifying the reliability of the financial statements distributed by management. Moreover, the managers are reporting on the results of their own actions, which they are in a position to manipulate. It is only fair, therefore, to have a third party assess the veracity of their assertions. In a legal parlance, this is referred to in the Latin maxim *nemo iudex in causa sua*, one cannot be a judge in his own cause.

ZUBIAURRE, on the other hand, argues as follows:

Todo aquel que pretende relacionarse con la sociedad no puede fiarse ciegamente de las cuentas presentadas por los administradores por lo que su revisión por auditor «competente e independiente» aumenta la seguridad sobre las mismas.⁷²

Therefore, it is only reasonable that there should be some form of independent verification to ensure the objectivity, reliability and relevance of such financial information.⁷³ So for the sake of transparency and credibility, an independent check on the work of the management was established through audit. The Securities Act of 1934 enshrined this under section 13(a) (2) by requiring that financial statements be accompanied by an auditor's report.⁷⁴ The Spanish legislator in obtaining credible accounts statements has also opted for a competent and independent person. This provision is found under section 1.3 LAC which reads thus:

⁷¹ STS de 9 de octubre de 2008 (RJ 2008/6042).

⁷² ZUBIAURRE A. G., *Los Aspectos Jurídicos de la Independencia del Auditor de Cuentas*, Pamplona, Thompson Reuters, 2012, p. 38

⁷³ ZISA argues in turn that auditors serve as "a filter of cynicism, ensuring that the investor has complete information upon which to base an investment decision." See ZISA, J. W., "Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information", *Campbell Law Review*, 11, 1989, p. 125, accessed July 3, 2012 at <http://scholarship.law.campbell.edu/cgi/viewcontent.cgi?article=1175&context=clr>.

⁷⁴ According to MARINELLI, the Securities laws principal aim is to place the owners of securities on parity, so far as possible, with the management of the corporations, and to place the buyer on the same plan so far as available information is concerned with the seller." See MARINELLI, J. A., "The Expanding Scope of Accountants' Liability to Third Parties", 23, *Case W. Res. L. Rev.*, 23, 1971, p. 126.

La auditoría de cuentas tendrá necesariamente que ser realizada por un auditor de cuentas o una sociedad de auditoría, mediante la emisión del correspondiente informe y con sujeción a los requisitos y formalidades establecidos en esta Ley.⁷⁵

All companies required to prepare financial statements are therefore obligated to submit same to an audit. LEE argues that the intention here is “that, because the information is supported by an expert and independent opinion, it will be accepted and used with complete confidence. The structure of the company, with ownership often divorced from, justifies this intention.”⁷⁶

These comments drive home the pivotal role the audit plays in keeping proper legal check on the management. Today the concept of the “independent” public accountant is recognized in all company laws, and auditors have already consolidated their position in corporate governance. Accordingly, the auditing industry has grown into a sophisticated global network of audit firms, providing services that range from audit to non-audit services.

6. AUDITING IN THE UNITED STATES LEGAL SYSTEM

6.1 COMPANY LAW AND INTERSTATE COMMERCE

In the United States mandatory financial statements are found under both federal and state laws. Audit in the United States is, therefore, regulated by federal as well as state legislations.⁷⁷ One of the most fundamental aspects of the United States government is not only the traditional separation of powers but also the vertical separation between the federal government and the states.⁷⁸ The United States congress has power under the Interstate Commerce Clause to regulate commerce amongst the states,⁷⁹ but the residual

⁷⁵ “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas” [hereinafter “LAC”]. See Also articles 263 to 269 of the LSC.

⁷⁶ LEE T. A. (1972) in COOKSON, C. R., *Delictual Liability...*, op. cit., p. 6.

⁷⁷ Please see JONES, R. M., “Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate”, *Wake Forest Law Review*, 10, 2006, p. 111.

⁷⁸ ALLMENDINGER, C., “Company Law in the European Union and the United States: A Comparative Analysis of the Impact of the EU Freedoms of Establishment and Capital and the U.S. Interstate Commerce Clause”, 4 *Wm. & Mary Bus. L. Rev.*, 2013, p. 72, accessed July 8, 2013 at <http://scholarship.law.wm.edu/wmblr/vol4/iss1/4>.

⁷⁹ Article I, Section 8, Clause 3 of the United States Constitution.

legislative powers are granted to the states.⁸⁰ Accordingly, congress is prohibited from encroaching on the powers of the states to legislate on their internal affairs. The states therefore maintain their sovereignty and control over many aspects of everyday life and conduct of business within their jurisdiction like contracts, property and personal status rights, among others.⁸¹ The federal government is only granted those powers that the states have ceded to it, such as regulation of interstate and international commerce.⁸²

Companies in the United States are therefore creatures of state legislation and are subject to the laws of states in which they are incorporated. Consequently, the regulation of the internal affairs of the company like its constitution, memorandum and articles of association, directors, auditors' duties and rights as well as their liabilities have developed at state levels.⁸³ Nonetheless, auditor's duties to investors who may buy or sell shares have developed through federal securities legislations. Securities legislations are set out at federal level but company law operates at state level with the attendant variations from one state to another.⁸⁴

7. THE SPANISH LEGAL ENVIRONMENT

7.1 THE EUROPEAN SINGLE MARKET EXPERIENCE

Spain's constitutional framework may perhaps be better compared with that of the United States as a constituent member of Single European Market. Given that since its inception, the European Union common market experiment has been compared with the economic constitution of the United States.⁸⁵ The EU member states, like individual States of the United States are said to be in competition against one another in the same market superstructure.⁸⁶

⁸⁰ See the Tenth Amendment to the US Constitution.

⁸¹ CUNNINGHAM, G. M., "Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A", *Global Perspectives on Accounting Education*, 3, 2006, p. 31, accessed August 7 2013 at <http://gpae.bryant.edu/~gpae/Vol3/Enron%20and%20Aurhur%20Andersen.pdf>.

⁸² Id

⁸³ BERNSTEIN, H., "Civil Liability for Pure Economic Loss under American Tort Law", *The American Journal of Comparative Law*, 46, 1998, p. 111, accessed January 7 2013 at http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5602&context=faculty_scholarship.

⁸⁴ BUSH, T., FEARNLEY, S. & SUNDER, S., "Auditor Liability Reforms in the UK and the US: A Comparative Review", 2007, p. 8, accessed May 8 2009 at <HTTP://DEPOT.SOM.YALE.EDU/ICF/PAPERS/FILEUPLOADS/2575/ORIGINAL/07-33.PDF>.

⁸⁵ ALLMENDINGER, C., *Company Law...*, op. cit., p. 69. See also LELEUX, P., "Corporation Law in the United States and in the E.E.C.", *Common Market .L. Rev.*, 1967, p. 133.

⁸⁶ Id

Unlike in the United States where company law evolved within an established federal constitutional setting, the Spanish company law like other European countries is fundamentally defined by national constitution and tradition. It was the Treaty of Rome and presently the Treaty on the Functioning of the European Union that formed a new regional constitutional framework for company law,⁸⁷ albeit, alongside their national constitution. As in the United States, there is a division of power between the institutions of the European Union and the national governments. For instance, the competence to regulate the correct functioning of the common market rests with the legislative organ of the European Union as provided by article 114 TFEU as follows:

The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.

The power ceded by the member states to the European Union is for the attainment of the objective of the common market. Apart from this power, all other legislative powers remain with member states. The EU treaty is very explicit on this, as it provides that “the Union shall act only within the limits of the competences conferred upon it by the member states in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States.”⁸⁸

Member states maintain the inherent right to determine their internal affairs and legislate in matters that relates to contracts, laws of personal status as well as commerce.⁸⁹ Member states shall however not make laws or rules to restrict or discriminate against the right of establishment,⁹⁰ as elucidated by the European Court of Justice in the case of GEBHARD as follows:

⁸⁷ Consolidated Version of the Treaty on the Functioning of the European Union, Sept. 5, 2008 O.J. (C 115/59) [hereinafter TFEU].

⁸⁸ Article 5 (2) of the EU Treaty

⁸⁹ Directives emitting from the EU will still have to be adapted by Member States’ parliaments being the relevant competent legislative authority.

⁹⁰ Article 49 (2) defines freedom of establishment as the right to undertake or pursue activities under the same conditions as the nationals of the host nation.

National measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfill four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.⁹¹

8. THE POSITION OF AUDITORS

Pursuant to section 301 of Sarbanes-Oxley, the auditor in the United States is to be appointed, retained and compensated by the audit committee. Only qualified person possessing the requisite knowledge and technical skill can be appointed as auditor statutorily referred to as Certified Public Accountant.⁹² Under various states legislations there are qualification requirement for the position of certified public accountant. In New York State,⁹³ for instance, this requirement is enumerated under article 149, section 7407 as follows:

1. To qualify for a license as a certified public accountant, an applicant shall fulfill the following requirements:

- (1) Apply for license;

- (2) Have the requisite education as prescribed by the state regulations;

- (3) Have the relevant experience satisfactory to the board of regents;

⁹¹ Case C-55/94, *Reinhard Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, 1995 E.C.R. I-04165, p. 36, quoted from ALLMENDINGER, C., *Company Law...*, op. cit., p. 76. It was also held in *Dieter Kraus v. Land Baden-Württemberg*, 1993 E.C.R. I-1663, p. 32 that any measure that hampers or places undue burden on individuals infringes their right of freedom of establishment even if it equally affects the nationals of the enacting Member State. A similar provision is found under Article VI, Clause 2 of the U.S. Constitution where it was explicitly stated that the laws made in accordance with the Constitution shall be the supreme law of the land. Any other law incompatible with the law made by federal law shall to the extent of its incompatibility be void, see *Marbury v. Madison*, 5 U.S. 137, 174 (1803).

⁹² Schedule A, pp. 25-27 of the Securities Act of 1933, requires that the balance sheet and account of profits and lost be "certified by an independent public or certified public accountant". See also section 12 of the Securities Exchange Act of 1934 and section 13(a) (2) of the Securities Exchange Act of 1934 that specifies that annual accounts must be certified by Independent Public Accountant. See also AICPA, *Codification of Statements on Auditing Standards AU S. 210.01* (CCH 1990).

⁹³ N.Y., EDN. LAW Section 7408, accessed November 5, 2013 at <http://codes.lp.findlaw.com/nycode/EDN/VIII/149/7408#sthash.JUSXiJ42.dpuf>.

- (4) Pass the necessary examination;
- (5) Be at least twenty-one years of age;
- (6) Be of good moral character as determined by the department; and
- (7) Pay the requisite practicing fee.

Sub-section (2) of this law provides for recognition of certain persons who although have not met requirements specified in paragraphs two and three of this section, but have had fifteen years experience in the practice of public accountancy to be sufficiently qualified for a certified public accountant license. Thus the right to audit accounts statements is only reserved to a duly qualified accountant, statutorily referred to as Certified Public Accountant who has passed the relevant examination and have met the additional practical experience required.⁹⁴ In addition, he or she is also required to constantly strive to maintain his or her competence through personal commitment to learning and professional improvement. She must also seek for the aforementioned license to practice in the state concerned.⁹⁵ Certified Public Accountants must have professional insurance and can practice individually, in partnership as well as by forming a body corporate.

The practice of accounting or auditing in Spain, like in the United States, also requires specialization. As such, only “auditor de cuentas” registered in the Official Registry of Auditors “Registro Oficial de Auditores de Cuentas” (ROAC) of the “Instituto de Contabilidad y Auditoría de Cuentas” (ICAC) is entitled to practice auditing through the professional associations recognized by law.⁹⁶ To be so qualified the person must satisfy

⁹⁴ These standards provide that one who offers professional services to another assumes a duty to exercise reasonable care and diligence and represents to that person that the auditor has the requisite skills commonly possessed by members of the profession. AU Section 230.03. The standards nonetheless cautions that no matter how capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing. AU Section 201. 02

⁹⁵ Accountants are required to obtain practicing license by any state they choose to practice in.

⁹⁶ “Instituto de Censores Jurados de Cuentas de España” (hereinafter “ICJCE”) in its definition contemplates the situation that every auditor or audit firm must be registered with one of the statutorily recognized professional associations in order to be entitled to practice auditing. See *Manual de Aditoría*, ICJCE, Madrid, 1982, p. 19. PACHECO CAÑETE however, argued on the contrary that belonging to any

the requirements outlined under articles 9 to 11 of the new Audit law before he or she can be admitted to practice auditing in Spain.⁹⁷ Auditors in Spain have an obligation to hold professional insurance or a similar guarantee as required under article 27 LAC,⁹⁸ and are held to a high standard of independence from their clients.⁹⁹

Precisely, on independence, the new measures reinforcing auditors' independence contemplated under article 5 of Regulation (EU) No 537/2014 has been incorporated into the "Ley 22/2015, de 20 de julio, de Auditoría de Cuentas." Under article 14 thereof, auditors are prohibited from being involved in management activities, tax services and must abstain themselves where their independence is in doubt. Above all, the ICAC must make sure that these requirements are complied with, "El Instituto de Contabilidad y Auditoría de Cuentas es el organismo encargado de velar por el adecuado cumplimiento del deber de independencia, así como de valorar en cada trabajo concreto la posible falta de independencia de un auditor de cuentas o sociedad de auditoría."¹⁰⁰

Auditors who are found to be in violation of these standards would be duly sanctioned.¹⁰¹ They may practice in sole proprietorship or in a "sociedad de auditoría de cuentas" as provided under articles 3 and 8.1 of LAC respectively. The "sociedad" however is liable for damages occasioned by their member's negligence in the course of performing the audit.¹⁰²

professional association is not obligatory under the Audit Law, being registered in the "Registro Oficial de Auditores de Cuentas" is sufficient. Please see PACHECO CAÑETE, M., *Regimen Legal...*, op. cit., p. 32.

⁹⁷ See Also article 25 of "Real Decreto 1517/2011, de 31 de octubre, por el que se aprueba el Reglamento que desarrolla el texto refundido de la Ley de Auditoría de Cuentas, aprobado por el Real Decreto Legislativo 1/2011, de 1 de julio" (hereinafter "RAC").

⁹⁸ The quantity of the insurance sum is to be determined by "Ministerio de Economía y Hacienda" in proportion to the size of the business.

⁹⁹ See article 14 and 15 of the LAC. Auditors must not only be independent but must also be seen to be so. For this reason, auditors are advised to abstain from undertaking an audit in situations contemplated under article 16 to 20 or situations in articles 23, 25, 39 and 41 LAC.

¹⁰⁰ Article 14.5 LAC.

¹⁰¹ Please see article 68 LAC. ICAC in exercise of its sanction regime can fine an auditor or strike out his name off the ROAC depending on the gravity of the offence.

¹⁰² See article 26 LAC. It is also noteworthy that any liability caps that may be negotiated by an auditor and his client do not affect third party rights. However, under the new law liability is proportionate to the fault of the auditor.

8.1 THE FUNCTION OF AUDITORS

Auditors by law do not have direct responsibility in corporate governance yet they play an important role in it. This is because the modern company usually depends on its public image to attract capital to fund its activities. In transmitting this image the company inevitably will require the independent evaluation of its accounts by auditors, which in turn will give that confidence and add value to the company's accounts statements. Moreover, to meet their obligation to shareholders company directors need relevant and reliable information. Auditors help them achieve that goal.

The content of auditor's duties and accounting services offered to clients may vary from Spain to the United States. However, the core function of auditors common to both systems is to perform an audit and express an opinion on the "fairness" of a company's financial statements.¹⁰³ Although these duties are generally spelt out by law, auditor's relationship with the client is essentially contractual.¹⁰⁴ Their certificate is primarily prepared in the shareholders' interest. Auditors must verify and report to the shareholders if the books of accounts required by law have been maintained and the provisions of the law has been complied with by the company. If those books of accounts are kept, it is their duty to examine them together with the financial statements with a view to informing the shareholders of whether the accounts are a fair representation of the financial position of the company.

An audit can, therefore, be defined as a systematic and objective examination of a company's financial statements which results in an opinion expressed by the auditor.¹⁰⁵ HAGEN, on the other hand, defined audit as an independent inquiry made by accountant into how fairly entity's financial statements reflect its actual financial position.¹⁰⁶ It follows that the responsibility for preparing financial statements rests wholly on the management. The auditor however has the duty to express an opinion on whether the

¹⁰³ PANTTAJA, R. S., Accountants' Duty..., op. cit., p. 931.

¹⁰⁴ KATSORIS, C. N., "Accountants' Third Party Liability-How Far Do We Go?" *Fordham L. Rev.*, 36, 1967, p. 193, accessed May 10, 2013 at <http://ir.lawnet.fordham.edu/flr/vol36/iss2/3>.

¹⁰⁵ GRUBBS, J. K. & ETHRIDGE J. R., "Auditor negligence liability to third parties revisited", *Journal of Legal, Ethical and Regulatory Issues*, 10, 2007, p. 76.

¹⁰⁶ HAGEN, W. W., II, "Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS", *J. Contemp. L.*, 13, 1987, p. 66.

financial statements fairly present the economic position of the company and results of operations are consistent with generally accepted accounting principles.¹⁰⁷

The Spanish legislator also embraces the role of auditors in the protection of the company as a going concern. Not because auditing is a guarantee and it is without flaws but as another wall of protection and for that matter an independent one. Therefore, in carrying out this function, the auditor must not only be conversant with the provisions of the Audit Law but also strictly comply with them. Article 1.2 LAC defines auditing as follows:

Se entenderá por auditoría de cuentas la actividad consistente en la revisión y verificación de las cuentas anuales, así como de otros estados financieros o documentos contables, elaborados con arreglo al marco normativo de información financiera que resulte de aplicación, siempre que dicha actividad tenga por objeto la emisión de un informe sobre la fiabilidad de dichos documentos que pueda tener efectos frente a terceros.¹⁰⁸

An auditor is to examine annual accounts and other financial documents prepared in accordance with relevant financial reporting framework and applicable law to form an opinion on the reliability of such accounts.¹⁰⁹ The main objective of the auditor is to verify and form an opinion as to whether the annual accounts give “true and fair view” of the company.¹¹⁰

In carrying out this responsibility, auditors have a duty growing out of contract to do it with due diligence and care proper of their calling and a duty imposed by law to make it objectively, independently and without fraud.¹¹¹ The auditor’s duty is however confined to expressing opinion based on sound accounting principles applied and does not in any way guarantee the financial statements. In understanding the proper function of an

¹⁰⁷ AU S. 110. 03.

¹⁰⁸ See also article 4 RAC for the definition of audit of annual accounts.

¹⁰⁹ Id

¹¹⁰ Article 4.2 LAC.

¹¹¹ In the performance of financial audit the auditor has a responsibility to plan the audits in order to obtain “reasonable assurance” about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU Section 110.02.

auditor, the dictum of Lord DENNING in *Fomento (Sterling Area) Ltd v. Selsdom Fountain Pen Co. Ltd* is instructive. His Lordship states as follows:

It is said that he is bound only to verify the sum, the arithmetical conclusion; by reference to the books and all necessary vouching material and oral explanations...I think this is too narrow a view. An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional adder-upper or a subtractor. His vital task is to take care to see that errors are not made, be the errors of computation or errors of omission or commission or downright untruths. To perform this task, he must come to it with an inquiring mind —not suspicious of dishonesty — but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.¹¹²

This judicial opinion has been reechoed in Spain by Justice MARTINEZ-CALCERRADA in the dictum quoted below:

La auditoría de cuentas se configura en esta Ley como la actividad que, mediante la utilización de determinadas técnicas de revisión, tiene por objeto la emisión de un informe acerca de la fiabilidad de los documentos contables auditados; no limitándose, pues, a la mera comprobación de que los saldos que figuran en sus anotaciones contables concuerdan con los ofrecidos en el balance y en la cuenta de resultados, ya que las técnicas de revisión y verificación aplicadas permiten, con un alto grado de certeza y sin la necesidad de rehacer el proceso contable en su totalidad, dar una opinión responsable sobre la contabilidad en su conjunto y, además, sobre otras circunstancias que, afectando a la vida de la empresa, no estuvieran recogidas en dicho proceso. (...) Las cualidades de transparencia, fiabilidad y fidelidad son los exponentes a considerar por el auditor al verificar su informe tras la correspondiente actividad auditora: Transparencia, esto es, para que a través de esta cualidad ínsita en el informe se vea y se conozca, por no existir ningún obstáculo imperativo, cuál es esa realidad económica empresarial. Fiabilidad, es un instrumento medial, esto

¹¹² [1958] 1 All ER 11

es, que dicho informe por haber sido verificado por un profesional que goza de las correspondientes pericias, saberes o conocimientos, emite algo que ‘per se’ se cuenta con una general credibilidad análoga a una especie de fe pública contable-económica. Fidelidad, que dicho informe es exacto y seguro, porque los datos y conclusiones a que se contraen, responden a una verdad, esto es, que si el informe dice que el resultado económico de la empresa es ‘uno determinado’, se corresponda realmente o adecue en exactitud, a lo que se recoge en el mundo instrumental de los elementos que integran el activo de la empresa, porque sean ciertamente los allí indicados.¹¹³

The Spanish legislator, although, conscious of the fact that audit is borne out of a contractual relationship between an auditor and his client, had nonetheless made it clear that auditing is a public function as well.¹¹⁴ This is evident in the provision of article 19 RAC, which provides

La responsabilidad y actuación de los auditores de cuentas debe estar presidida por el principio de interés público que conlleva la actividad de auditoría de cuentas. En este sentido, los auditores de cuentas en el ejercicio de su actividad han de tener en consideración y actuar en todo caso con sujeción a los siguientes principios éticos: competencia profesional, diligencia debida, integridad y objetividad.

Under Spanish legal tradition, auditing is not seen as an end in itself but a means to an end. As such the “auditor de cuentas” is viewed as a professional whose work entails a responsibility towards his client as well as protecting shareholders and third parties interests.¹¹⁵ Auditors have a statutory duty to act not only in the interest of their clients, but rather for public good.¹¹⁶ Thus, apart from their contractual and professional duties,

¹¹³ STS de 10 de diciembre de 1998 (RJ 1998/1143).

¹¹⁴ As we shall see in the following chapters, the thesis that an auditor whose relationship with her client is contractual should also owe a duty to third parties is not without controversy. ARANA GONDRA, F. J., “Ley de Auditoría de Cuentas”, in SÁNCHEZ CALERO, F., *Comentarios a la Legislación Mercantil*, EDERSA, Madrid p. 392 is of the opinion that auditing is a contractual relationship therefore its rights and obligations must be derived from the contract. FERNANDEZ RODRIGUEZ, however, is of the view that auditors like other professionals are within the confines of the provision of article 1.902 of the Civil Code.

¹¹⁵ Article 1 LAC. See FERNANDEZ RODRIGUEZ, C., *El Auditor de Cuentas: Un estudio de Derecho Administrativo*, Marcial Pons, 1997, p. 192

¹¹⁶ Id. See also VALENZUELA GARACH, F., (ed.), *La información en la sociedad anónima y en el mercado de valores*, Civitas, Madrid, 1993, p. 162.

auditors are also responsible to the public and society in general. Accordingly, they have an obligation to be honest and impartial in their activity. They must maintain their professional integrity and ensure that financial reports they emit are accurate and reliable. Essentially, their function is seen not only in the service they render their clients but also in the effect their service would have on third parties, to whom they owe a duty of care as well.¹¹⁷ As enunciated in the dictum of Judge SOLDEVILA FRAGOSO below:

De lo expuesto se deduce, de forma inequívoca, que con el ejercicio de esta actividad se persigue proteger un interés público identificado con la garantía de la máxima transparencia en el análisis de la información económico-contable de las empresas, cuyo respeto será el parámetro desde el que debe juzgarse el ajuste legal de la actividad profesional de los auditores de cuentas.¹¹⁸

8.2 THE IMPORTANCE OF AUDIT

It is submitted that the substance of auditing lies in the fact that an enterprise seeking financing through loans, stock offerings, and other forms of credit enhancement invariably, looks to investors and creditors.¹¹⁹ Creditors and investors, in turn, look to the enterprise's financial audit in making lending and investing decisions.¹²⁰ Auditors, therefore, provide the third parties (such as lenders and creditors) with assurances and the external and objective check on the way financial statements are prepared and presented.¹²¹ BEVIS highlighted this position as follows:

The statements of large corporations are readily accessible and widely disseminated; they provide the average investor with his most significant, at times his only, basis for decision. A notation on such a statement that it has been certified by an "independent" public accountant and that it reflects his opinion as

¹¹⁷ The provision of article 1 LAC above emphasizes the importance of accurate and responsible information for the investing public.

¹¹⁸ Sentencia de 14 de febrero 2005 (JUR 2007\209229)

¹¹⁹ SCHERL, J. B., "Evolution of Auditor Liability to Non Contractual Third Parties: Balancing the Equities and Weighing the Consequences", *American University Law Review*, 44, 1994, p. 256, accessed June 7 2011 at <http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1526&context=aulr>.

¹²⁰ Id.

¹²¹ For further reading on the role of auditors, please refer to Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), 1992, par 5.1, accessed June 7 2011 at Available at: <http://www.ecgi.org/codes/documents/cadbury.pdf> .

to the financial position of the company cannot but create in the investor a sense of security as to the accuracy of the report he is reading. He cannot, except naively, expect total accuracy. But he can, and generally does, expect that the statement is free of severe distortions and therefore a reasonably useful investment tool.¹²²

Auditors frequently point out in debates about liability, that it is the company, not the accountant, that prepares the financial statements.¹²³ Nonetheless, it is their function to evaluate the assertions made by the management, validate and give credibility to those assertions. If they “issue a clean audit, indicating a healthy enterprise, investors and creditors are often willing to provide credit or needed capital.”¹²⁴ In essence, investors and creditors are attracted to an enterprise based on its financial stability, which is certified by the audit.”¹²⁵ As noted by IMPASTATO, “this validation [by the auditor] is meant to make the financial information reliable; therein lies the value of auditing.”¹²⁶

Accordingly, auditor’s certification lends credibility to the presentation by managers of the financial position of the company which in turn increases reliance on them. This good will is earned by auditors thanks to their reputation for objectivity and professionalism, a virtue that makes companies hire their services. The mere fact that sellers of stocks will seek for auditors to audit their finances demonstrates the importance of auditors’ reputation of independence and objectivity to the investing public. The same good reputation has been instrumental to global dominance of the audit market by the so called BIG FOUR.¹²⁷ These firms attract large companies because of their reputation which is recognized worldwide. Entities that contract their services have the benefit of the fact that potential investors and creditors recognize their

¹²² BEVIS, H. W., “The Certified Public Accountant’s Attest Function in Modern Society”, *Journal of Accountancy*, 113, 1962, p. 28.

¹²³ FEINMAN, J. M., “Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology”, *Florida State University Law Review*, 31, 2003, p. 21, accessed October 12 2010 <http://www.law.fsu.edu/journals/lawreview/downloads/311/Feinman.pdf>.

¹²⁴ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 76.

¹²⁵ SCHERL, J. B., Evolution of Auditor Liability..., op. cit., p. 257.

¹²⁶ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 76.

¹²⁷ This is the name used to refer to PricewaterhouseCoopers, (PwC), Deloitte Touche Tohmatsu Limited (Deloitte), KPMG and Ernst & Young, the four largest international audit firms. They are credited to handle the vast majority of audits for private as well as publicly traded companies.

reputation and are assured of the reliability of their audit.¹²⁸ BEVIS highlighted the status of auditors as follows:

...as a trained observer of economic activities, relationships and status is the most appropriate agent to [certify the financial statements]. His competence has been identified by state authority. His position as independent auditor, which involves a peculiar responsibility to third persons, is not assumed by those in private employment.¹²⁹

8.3 AUDITOR'S RIGHT OF ACCESS TO INFORMATION

As seen above, in carrying out their function auditors have duties imposed on them by the law which are conditions precedent in any proper audit. To facilitate their ability to accomplish their laid down statutory task, auditors have also been conveyed a series of rights. Among these rights are right of access to books of accounts and right to require information or explanation from the officers of the company. Company officers have an obligation to furnish the relevant information to the auditor without any concealment. The Sarbanes-Oxley Act prohibits company officers or anyone under their direction from engaging in an attempt to mislead the auditor or misstate financial statements. They must also desist from acts that may improperly influence the audit process and the accuracy of the financial statements.¹³⁰ Section 303 of the Act provides:

It shall be unlawful,...for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

Rule 13b2-2 made under section 303 made it much clearer by providing that directors and officers of the company are prohibited from either directly or indirectly:

¹²⁸ VICK argues that clients of these audit firms who seek capital from the financial markets hope that auditor's opinion will add to their financial statements the credibility necessary to gain access to financial markets. See VICK, S., "Bily v. Arthur Young & Co.: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play", *Loy. L.A. L. Rev.*, 26, 1993, p. 1342, accessed June 8 2012 at <http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=1810&context=llr>.

¹²⁹ BEVIS, H. W., *Certified Public...*, op. cit., p. 28.

¹³⁰ One important signature of the Sarbanes-Oxley is to focus more on fairness in the audit process rather require strict compliance with GAAP. The Act thus requires directors of companies to personally certify the fairness of the financial statements.

- a. Making or causing to be made a materially false or misleading statement to an accountant; or
- b. Omitting to state to an accountant, or causing another person to omit to state to an accountant, any material fact necessary to make statements made, in light of the circumstances under which they were made, not misleading.

A director or any officer who willfully violates the above prohibitions may be criminally penalized under section 32(a) of the Act.¹³¹ The director may as well be liable under state law for breach of fiduciary duty.

According to SEC, Rule 13b2-2 is meant to “supplement the rules currently in Regulation 13B-2, which address the falsification of books, records, and accounts, and false or misleading statements, or omissions to make certain statements, to accountants.”¹³² By this Rule SEC was provided with “an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer’s financial statements.”¹³³

Since auditors do not control the company’s internal affairs, they depend on the directors of the company in order to prepare their report. Therefore, the veracity of the auditors’ report depends on the directors’ collaboration in providing the auditor with accurate and truthful information. It is submitted that the importance of section 303 Sarbanes-Oxley Act is to hold the directors and officers of the company responsible if they fail to do so.¹³⁴

Under Spanish law, auditors’ right to information is to be found under the LAC where article 6 of the law provides that:

¹³¹ SKINNER, D. C., “Director Responsibility and Liability Exposure in the Era of Sarbanes-Oxley”, *The Practical Lawyer*, 2006, p. 36, accessed June 8 2012 at http://www.arnoldporter.com/resources/documents/Practica_Lawyer_Skiner.pdf.

¹³² SEC Release No. 34-47890 (May 20, 2003).

¹³³ Id

¹³⁴ The law here subjects the officers to individual criminal charges and perhaps civil liability in order to motivate them to become actively involved in financial reporting processes.

Las entidades auditadas estarán obligadas a facilitar cuanta información fuera necesaria para realizar los trabajos de auditoría de cuentas; asimismo, quien o quienes realicen dichos trabajos de auditoría estarán obligados a requerir cuanta información precisen para la emisión del informe de auditoría.¹³⁵

Auditors shall have a right of access to the company's accounting records and shall be entitled to require from the company's officers such information and explanations they deem necessary for the performance of the audit.¹³⁶ Where for any reason the company would not avail auditors of the required information, the auditors shall document that in their working papers. In the case of Spain, it is the Penal Code, under article 290 that penalizes company officers who falsified accounts, withheld documents or information that had jeopardized the interest of the company or third party.

Finally, like any other member of the company, the law has accorded the auditor with the right to attend general meetings of the company and to receive notice and any communication related therewith.

8.4 AUDITOR PROFESSIONAL STANDARDS

Over the years auditors have assumed a critical position in corporate governance as well as in modern commerce. Their role in providing free flow of reliable information does not only sustain modern capital-market economy but also helps to maintain an orderly functioning of commerce.¹³⁷ They are entrusted with this responsibility by the law because of their competence, objectivity and their concern for public interest. Consistent with this status, they are required to assume 'an obligation of self-discipline above and beyond the requirements of laws and regulations.'¹³⁸ In other words, mere compliance with the letter of the law may not be enough; auditors must strive to act in the spirit of the law, which requires complete honesty on their part.¹³⁹ Accordingly, users of

¹³⁵ Article 56 of RAC also has the same provision

¹³⁶ Auditors are required under Article 30 and 31 LAC to maintain this information secret and keep custody of these documents together with their working papers for a period of up to five years.

¹³⁷ Mr. TURNER argued in similar vein that "credible financial information is the "lifeblood" to the capital markets. It is paramount to confidence and ability of those markets to attract capital." See the testimony of TURNER, L. N., before the Senate Subcommittee on Securities, Insurance and Investment on The Role of the Accounting Profession in Preventing another Financial Crisis Dirksen Senate Office Building April 6, 2011, p. 2.

¹³⁸ ET Section 51, Code of Professional Conduct and Bylaws (as of June 1, 2013).

¹³⁹ It has been held in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) that an accountant's compliance with the generally accepted accounting standards was not conclusive evidence that he acted in

financial statements as well as the general public have reasons to believe that auditors will act with honor and integrity placed on them by the society in performing their function. As SUNDEM points out:

After all, even though financial statements are the responsibility of management, shareholders hire auditors to protect their interests and to add credibility to the financial information disclosed by firms. To add this credibility, auditors need both expertise and integrity. Expertise assures us that if there is a financial reporting irregularity, the auditor will discover it. Integrity assures us that auditors will disclose any irregularity they find. These two qualities are essentially multiplicative — if either is missing, the other has no value.¹⁴⁰

To ensure quality control in the conduct of the audit, auditors are required to follow certain authoritative auditing standards to provide them with a measure of audit quality and help them achieve the objectives of the audit. These are Generally Accepted Auditing Principles (GAAP)¹⁴¹ as adopted from time to time by the American Institute for Certified Public Accountants (AICPA),¹⁴² the Securities and Exchange Commission (SEC), and the Public Company Accounting Oversight Board (PCAOB).¹⁴³ Pursuant to

good faith. In a similar vein, article 19.2 RAC provided that “Los auditores de cuentas han de actuar de acuerdo con las normas que regulen la actividad de auditoría de cuentas atendiendo no solo a la letra, sino también al espíritu en que aquellas se inspiran.”

¹⁴⁰ SUMDEN, G. L., “Ethics and Financial Reporting in a Post-Enron Environment”, CGA Accounting Research Centre conference, 2003, p. 2, accessed May 4, 2011 at https://www.cga-pdnet.org/non_verifiableproducts/articlepublication/ethicsfinancialreporting/ethicsfinancialreporting.pdf

¹⁴¹ According to SEPTIMUS, GAAP is a term of art in accounting which encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Rather than a set of codified procedures, GAAP is therefore fluid and may change from time to time as a result of pronouncements by agencies designated by the AICPA or through procedures that “become acceptable as a result of common usage by business.” Professional Standards s. 411.02 at 485, see also SEPTIMUS, J., “Accountants’ Liability for Negligence—A Contemporary Approach for a Modern Profession”, *Fordham Law Review*, 49, 1979, p. 403.

¹⁴² Since 1917, The American Institute of Certified Public Accountants (AICPA) has been known to be developing accounting principles in an effort to guide, strengthen, and improve the auditing practice, SCHERL, J. B., *Evolution of Auditor Liability...*, op. cit., p. 261. The Professional auditing standards address the nature of evidence to be obtained and examined in the conduct of audits. It is however, worthy of note that since the advent of the PCAOB Statements on Auditing Standards, produced by the AICPA’s Auditing Standards Board, is now for private companies; while PCAOB standards are for publicly-held companies.

¹⁴³ GRUBBS, J. K. & ETHRIDGE J. R., *Auditor Negligence...*, op. cit., p. 77. With the provisions of the Sarbanes-Oxley Act of 2002 coming into effect and the subsequent creation of the Public Company Accounting Oversight Board (PCAOB) in 2002, the Act “authorized the PCAOB to establish auditing and related professional practice standards to be used by registered public accounting firms. PCAOB Rule 3100, Compliance with Auditing and Related Professional Practice Standards, requires the auditor to comply with all applicable auditing and related professional practice standards.” BARRACK, J. A.,

its power under section 103 of the Sarbanes-Oxley Act, the PCAOB has adopted as interim standards, on an initial transitional basis, the generally accepted auditing standards by the AICPA in existence since April 16, 2003. These standards known as the 10 reporting standards are listed below:

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.
4. The auditor must adequately plan the work and must properly supervise any assistants.
5. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
6. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.
7. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.
8. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

"Auditor Responsibility under the Federal Securities Laws: A Note from the WorldCom Securities Litigation" *American Journal of Trial Advocacy*, 29, 2005, p. 4 fn. 12.

9. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
10. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons there for in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

Auditors in Spain are also obliged to adhere to professional standards and any other rules and regulations as well as guidelines that may be issued from time to time under the Audit Law.¹⁴⁴ These standards are referred to under article 17.1 RAC, which states:

Las normas de auditoría a que se refiere el artículo 6.2 del texto refundido de la Ley de Auditoría de Cuentas constituyen los principios y requisitos que deben observar los auditores de cuentas en la realización del trabajo de auditoría de cuentas y sobre las que deben basarse las actuaciones necesarias para expresar una opinión técnica responsable e independiente.

The standards are to be in accordance with the general principles and practice allowed in the member states of the EU as developed and adapted by the relevant professional bodies and approved by the ICAC.¹⁴⁵ Apart from this, auditor is enjoined to adhere to the highest ethical standards, as outlined in article 19 RAC as follows:

La responsabilidad y actuación de los auditores de cuentas debe estar presidida por el principio de interés público que conlleva la actividad de auditoría de cuentas. En este sentido, los auditores de cuentas en el ejercicio de su actividad han de tener en consideración y actuar en todo caso con sujeción a los siguientes

¹⁴⁴ Article 2 LAC.

¹⁴⁵ See article 17 RAC and RUIZ-BARBADILLO, E., HUMPHREY, C. & GARCIA BENAÚ, M. A., "Auditors versus Third Parties and Others: The Unusual Case of the Spanish Audit Liability "Crisis", *Accounting History*, 5, 2000, p. 124. The European Union, on the other hand, has by Regulation (EC) No. 1606/2002 required listed companies to use International Accounting Standards (IAS) from January 1, 2005.

principios éticos: competencia profesional, diligencia debida, integridad y objetividad.

Incidentally, professional ethics code outlined under article 19 RAC are, *mutatis mutandis*, similar with the provision of the AICPA code sections 51 to 56 that outlined the etiquettes of integrity, objectivity, due care and public interest.¹⁴⁶

Integrity, according to the AICPA code, more than following ‘specific rules, standards, or guidance, or in the face of conflicting opinions,’ requires the auditor to search for his inner conscience and be convinced of whether or not he or she is doing the right thing. Objectivity is said to be the hallmark of a professional. An auditor therefore must and exhibit objectivity, honesty and impartiality as a true professional. The auditor is also required to discharge his or her responsibilities with diligence and competence.¹⁴⁷ The auditor by his or her calling is obliged to carry his or her duties with due care and also endeavor to abide by the professional ethics of integrity and objectivity always bearing in mind the public function he or she serves.

9. THE CONDUCT OF AUDIT IN THE UNITED STATES

9.1 THE HUMBLE BEGINNING

According to SEPTIMUS, an accounting function may be divided into the three major categories of the audit, tax practice, and management advisory services.¹⁴⁸ However, the great majority of reported cases of third party liability concern accountants in the performance of audit function which constitute the bulk of their revenue.¹⁴⁹

The audit process, HAWKINS argues, consists of the examination of the financial records of a business entity that leads to a collection of data, the formulation of a conclusion based upon that data, and the presentation of that conclusion in a report on the financial

¹⁴⁶ ET Sections 51 to 56.

¹⁴⁷ Competence has been pointed out by the RLAC as well as the AICPA code to be a continuing exercise and have placed this responsibility squarely on the shoulder of the auditor to strive for it by individual endeavor to improve his or her knowledge through continued education.

¹⁴⁸ SEPTIMUS, J., “Accountants’ Liability..., op. cit., p. 401.

¹⁴⁹ Id. Accountants are known to provide a variety of services to their clients, among which are tax and estate planning as well as preparing tax returns. But majority of liability cases brought against them come from audit services. See FEINMAN, J. M, Liability of Accountants..., op. cit., p. 20.

statements.¹⁵⁰ This process may vary according to the terms of engagement. Clients may sometimes seek a “complete audit,” i.e. a reconstruction of all their financial transactions for a certain period of time.¹⁵¹ Otherwise the client may only need a formulation of conclusions from a sample of financial transactions, what is known in accounting parlance as “test audit.” Irrespective of the type of audit required, the audit process can be divided into four general stages from inception to the conclusion.¹⁵²

Upon his engagement, the first step taken by the auditor in the audit process is to familiarize with the nature of the client’s business, usually focusing primarily on planning the audit to conform to the terms of his engagement.¹⁵³ This includes a study of client’s industry conditions, its management characteristics, and possibly its financial reporting methods.¹⁵⁴ The preliminary study provides the accountant with knowledge of the prior financial statements as well as basic accounting procedures of the client. Armed with this information, the accountant then goes on to make an evaluation of the client’s internal control system and develop an “audit program.”¹⁵⁵

The importance of the evaluation of the client’s internal control structure is that it determines the nature, timing and extent of the tests to be performed by the auditor.¹⁵⁶ This, of course, goes without saying that financial statements prepared under a strong and effective internal control structure are more likely to give a fair presentation of the company’s financial position and its results of operations. Even as such; EPSTEIN & PERSSICO argue that “an auditor is required to corroborate the assertions provided by management. Specifically, she must gather appropriate audit evidence sufficient to opine on the financial statements taken as a whole, and thus implicitly on every material assertion implicit in those financial statements. The accumulation of enough audit evidence to reasonably support the assertions in the financial statements, as well as those provided in the management representation letter is required; representations from

¹⁵⁰ HAWKINS, C. S., “Professional Negligence Liability of Public Accountants”, *Vand L. Rev.*, 12, 1959, p. 803.

¹⁵¹ SEPTIMUS, J., *Accountants’ Liability...*, op. cit., p. 401.

¹⁵² *Id.*

¹⁵³ PASCHALL, S. S., “Liability to Non-Clients: The Accountant’s Role and Responsibility”, *Mo. L. Rev.*, 53, 1988, p. 699.

¹⁵⁴ SEPTIMUS, J., *Accountants’ Liability...*, op. cit., p. 402.

¹⁵⁵ The audit program usually serves as a detailed guide to the audit.

¹⁵⁶ SEPTIMUS, J., *Accountants’ Liability...*, op. cit., p. 403.

management are not appropriate substitutes for performing auditing procedures and gathering audit evidence.”¹⁵⁷

At the completion of the preliminary plans, the auditor makes a skeleton audit that is based on the trial balance that he will review after he makes tests upon internal control. The more an auditor can rely on the client’s internal control function, the fewer auditing procedures he will need to formulate an opinion on the financial statements.¹⁵⁸ However, it is necessary to point out that no matter how good and reliable internal control structure of a client might be; some audit procedures might still be needed.¹⁵⁹ As clearly illustrated by SEC in the following words:

An independent examination is a check on representations of management however honest and competent that management may be, and reliance on managerial virtues is not a check.¹⁶⁰

The auditor will then revise the audit program to determine which other remaining audit procedures need to be applied in the final audit. The auditor must always be aware of the possibility of deliberate misrepresentation by management.¹⁶¹ He may need to expand the revised audit program where he suspects that assertions in the account balances are likely to be misstated. Likewise, if certain evidence arises in the course of the audit indicating the possibility of fraud, he should also revise his audit program to

¹⁵⁷ EPSTEIN, B. J. & PERSSICO, N., “Auditor Liability and Litigation: The Management Representation Letter”, *JD Supra Law news*, 2013, p. 3, accessed December 8 2013 at <http://www.jdsupra.com/legalnews/auditor-liability-and-litigation-the-ma-74351/pdf>.

¹⁵⁸ The audit of these financial statements may relatively require less rigorous audit procedures than those prepared under a weak control system.

¹⁵⁹ SEPTIMUS, J., *Accountants’ Liability...*, op. cit., p. 403.

¹⁶⁰ See WALKER, C. M., “Accountants’ Liability: The Scierter Standard under Section 10b and Rule 10b-5 of the Securities Exchange Act of 1934”, *Marquette Law Review*, 63, 1979, p. 248, accessed July 16 2012 at <http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=2065&context=mulr>. In other words, no matter how well meaning and fair a management could be, this does not relieve the auditor of his responsibility of conducting a thorough audit, and “must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.” See *United States v. Natelli*, 527 F.2d 311 (2nd Cir. 1975), *cert. denied*, 425 U.S. 934 (1976).

¹⁶¹ For more on auditor’s duties, see FIFLIS, T. J., “Current Problems of Accountants’ Responsibilities to Third Parties”, *Vand. L. Rev.*, 28, 1975, p. 31. At page 79 FIFLIS observed that:

The auditor’s duty does not permit him to wait for an alarm bell to arouse him to investigation. He has a duty in the first instance to focus a skeptical eye on the accounts. That is the purpose of an audit - it is not merely an arithmetical check and a determination of compliance with form. One of the things GAAS specifically includes is a duty to look for the suspicious circumstances that in turn will raise the auditor’s duty to probe to the bottom.

highlight the fraudulent act. Once the audit program is set, the auditor applies the specified auditing procedures to the financial statements of the client. Each of the various procedures applied is subsequently recorded in the auditors' working papers.¹⁶²

The final phase in the audit process is the discussion of any outstanding questions with management and the completion of field work. The auditor then evaluates the results and chooses the appropriate audit report to issue depending on his findings. The auditor's report will state whether the financial statements are presented in accordance with generally accepted accounting principles, consistently observed in the current period in relation to the preceding period, and expresses an opinion regarding the financial statements as a whole.¹⁶³

9.2 THE AUDIT REPORT

The audit report is the culmination of the audit process and may be one of the following types; (1) An unqualified opinion,¹⁶⁴ (2) A qualified opinion, (3) An adverse opinion and (4) A disclaimer of opinion:

1. An unqualified opinion states that the accountant followed Generally Accepted Accounting Standards (GAAS) and that the financial statements fairly present the financial condition of the company in accordance with

¹⁶² "Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. Working papers also may be in the form of data stored on tapes, films, or other media." See AU Section 339A. 03

¹⁶³ AU Section 150. 02

¹⁶⁴ For an "unqualified" or "clean" report as sometimes referred to, the AICPA, UNDERSTANDING AUDITS AND THE AUDITOR'S REPORT 16 (1989), recommends the following language:

We have audited the . . . [financial statements of XYZ Company] . . . These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [XYZ] Company as of [dates], and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Generally Accepted Accounting Principles (GAAP). An unqualified opinion may sometimes contain explanatory language, as when the company has changed its accounting practice or when there is an unresolved uncertainty, such as significant pending litigation. As a practical matter, an unqualified opinion is almost a necessary result of an audit of large, publicly-held companies, and of smaller companies when the audit is needed to satisfy lenders or investors. If the auditor discovers discrepancies that may require a qualified report, the auditor and the client often will discuss, negotiate, and attempt to remedy the difficulties.

2. A qualified opinion states exceptions to the observance of GAAS, where the scope of the audit is limited or the auditor is unable to obtain necessary information, or to the fairness of the statements in accordance with GAAP, when the principles have not been observed or when not all necessary disclosures have been made.
3. An adverse opinion states that the financial statements are not fairly stated in conformity with GAAP.
4. A disclaimer of opinion is not an opinion at all; rather, the accountant states that the scope of the audit was not sufficient to enable it to render an opinion.¹⁶⁵

At the end of each financial year, company's financial statements accompanied by auditor's certificate as approved by the shareholders at a general meeting must be filed at the SEC. Auditors are now required to not only certify the integrity of their client's financial statements, but also assess the mechanisms that their clients have adopted to generate the financial information that goes into those statements.¹⁶⁶

Every shareholder has a right to receive a copy of the financial statements and to make extracts from them before an annual general meeting. However, when a company

¹⁶⁵ See FEINMAN, J. M., *Liability of Accountants...*, op. cit., p. 21.

¹⁶⁶ Section 404 (b) Sarbanes-Oxley Act and Robert G. Hubbard, "An Action Plan for US Capital Markets, International Finance", 10, 2007: p. 92, accessed June 6, 2010 at <http://www.gsb.columbia.edu/faculty/ghubbard/Articles.pdf>.

publishes its account with the aim of inviting the general public or any class thereof to read the financial statements, such must be accompanied by an auditor's report. In practice financial statements are also sent to third parties to attract investment, contracts and finance.¹⁶⁷

10. THE CERTIFICATE OF "AUDITOR DE CUENTAS"

The auditor in Spain, after a thorough investigation, will prepare a report and state whether the financial statements give a "true and fair view" as well as a representation of the company's asset in accordance with the law and accounting principles applied.¹⁶⁸ Where director's report is required, the auditor must also state whether in her opinion the information given in the director's report for the financial year for which the annual accounts are prepared is consistent with those accounts.¹⁶⁹ Finally, the auditor has to state that she is satisfied that the financial statement is a fair representation of the financial position of the company and that they are prepared in accordance with the audit law and applicable auditing standards.¹⁷⁰ However, the auditor does not pass on

¹⁶⁷ KHOURY L., Liability of Auditors..., op. cit., p. 242.

¹⁶⁸ Article 4 LAC.

¹⁶⁹ This law, nevertheless, is not of universal application to all types of audits. According to article 1.4 of LAC "Lo dispuesto en esta Ley no resulta aplicable a las auditorías de cuentas que se realicen por los órganos del sector público estatal, autonómico o local en el ejercicio de sus competencias, que se regirán por su legislación específica de conformidad con lo dispuesto en la disposición adicional segunda."

¹⁷⁰ Article 5 LAC. A typical example of an audit report that fulfills the requirements of article 5 LAC, according to Norma Internacional De Auditoría 700 (adaptada para su aplicación en España mediante Resolución del Instituto de Contabilidad y Auditoría de Cuentas, de 15 de octubre de 2013) is as follows:

INFORME DE AUDITORÍA INDEPENDIENTE DE CUENTAS ANUALES A los accionistas de ABC, S.A. [por encargo de.....][Destinatario correspondiente]:

Informe sobre las cuentas anuales

Hemos auditado las cuentas anuales adjuntas de la sociedad ABC, S.A., que comprenden el balance a 31 de diciembre de 20X1, la cuenta de pérdidas y ganancias, el estado de cambios en el patrimonio neto, el estado de flujos de efectivo y la memoria correspondientes al ejercicio terminado en dicha fecha.

Responsabilidad de los administradores en relación con las cuentas anuales

Los administradores son responsables de formular las cuentas anuales adjuntas, de forma que expresen la imagen fiel del patrimonio, de la situación financiera y de los resultados de ABC, S.A., de conformidad con el marco normativo de información financiera aplicable a la entidad en España, que se identifica en la nota X de la memoria adjunta, y del control interno que consideren necesario para permitir la preparación de cuentas anuales libres de incorrección material, debida a fraude o error.

Responsabilidad del auditor

Nuestra responsabilidad es expresar una opinión sobre las cuentas anuales adjuntas basada en nuestra auditoría. Hemos llevado a cabo nuestra auditoría de conformidad con la normativa reguladora de la auditoría de cuentas vigente en España. Dicha normativa exige que cumplamos los requerimientos de

the quality of the investment but rather the quality of the information respecting the investment; hence the auditor cannot guarantee these accounts. Since his or her obligation is to comply with the professional requirements of prudence, competence and due diligence, once those are fulfilled the auditor is deemed to have discharged his or her duty.

As in the case of the United States, in Spain as well financial statements together with auditor's certificate are to be presented before the shareholders at an annual general meeting¹⁷¹ and must be deposited at the Mercantile Registry within the same month of its approval.¹⁷² Moreover, once filed at the registry it becomes a public document and third parties can access it.¹⁷³ These documents are usually revealed to third parties by the companies for business ends.

ética, así como que planifiquemos y ejecutemos la auditoría con el fin de obtener una seguridad razonable de que las cuentas anuales están libres de incorrecciones materiales.

Una auditoría requiere la aplicación de procedimientos para obtener evidencia de auditoría sobre los importes y la información revelada en las cuentas anuales. Los procedimientos seleccionados dependen del juicio del auditor, incluida la valoración de los riesgos de incorrección material en las cuentas anuales, debida a fraude o error. Al efectuar dichas valoraciones del riesgo, el auditor tiene en cuenta el control interno relevante para la formulación por parte de la entidad de las cuentas anuales, con el fin de diseñar los procedimientos de auditoría que sean adecuados en función de las circunstancias, y no con la finalidad de expresar una opinión sobre la eficacia del control interno de la entidad. Una auditoría también incluye la evaluación de la adecuación de las políticas contables aplicadas y de la razonabilidad de las estimaciones contables realizadas por la dirección, así como la evaluación de la presentación de las cuentas anuales tomadas en su conjunto.

Consideramos que la evidencia de auditoría que hemos obtenido proporciona una base suficiente y adecuada para nuestra opinión de auditoría.

Opinión

En nuestra opinión, las cuentas anuales adjuntas expresan, en todos los aspectos significativos, la imagen fiel del patrimonio y de la situación financiera de la sociedad ABC, S.A. a 31 de diciembre de 20X1, así como de sus resultados y flujos de efectivo correspondientes al ejercicio anual terminado en dicha fecha, de conformidad con el marco normativo de información financiera que resulta de aplicación y, en particular, con los principios y criterios contables contenidos en el mismo.

Informe sobre otros requerimientos legales y reglamentarios

El informe de gestión adjunto del ejercicio 20X1 contiene las explicaciones que los administradores consideran oportunas sobre la situación de la sociedad, la evolución de sus negocios y sobre otros asuntos y no forma parte integrante de las cuentas anuales. Hemos verificado que la información contable que contiene el citado informe de gestión concuerda con la de las cuentas anuales del ejercicio 20X1. Nuestro trabajo como auditores se limita a la verificación del informe de gestión con el alcance mencionado en este mismo párrafo y no incluye la revisión de información distinta de la obtenida a partir de los registros contables de la sociedad. [Firma del auditor] [Fecha del informe de auditoría] [Dirección del auditor y número de Registro Oficial de Auditores de Cuentas]

¹⁷¹ Article 272 LSC.

¹⁷² Article 279 LSC.

¹⁷³ Article 281 LSC.

11. CONCLUSION

Apart from the useful information it provides to the management of a company about the effectiveness of its internal accounting system and the accuracy of information the system produces, audit also avails third parties with an independent evaluation of the company's financial statements and the process that produced them. As such an audit can be said to serve two purposes: first, it provides the directors and officers of the company with reasonable assurance in taking managerial decisions.¹⁷⁴ Second and critically, the auditor's validation is essential to third parties who might rely on the company's financial reports in making financial decisions. Invariably, prospective shareholders, investors, lenders, sureties and public authorities have a substantial interest in the auditor's work, often being the only independent and objective source of information available to them.¹⁷⁵ So to protect these investors and promote fair information exchange in the financial sector, the mainstay of modern information economies, regulations were established. However, more than compliance with rules and audit standards, auditors must be sensitive to the needs of investors and general public. Anything short of a reasonably accurate audit may lead to audit expectation gap, the subject of the next chapter.

¹⁷⁴ KHOURY, L., *Liability of Auditors...*, op. cit., p. 417.

¹⁷⁵ Id. at p. 418.

CHAPTER II

THE AUDIT EXPECTATION GAP QUESTION

1. INTRODUCTION

The expectation gap question has recently assumed important position in the audit literature because of the direct relation it has with auditor liability. This is all linked to the essence of audit itself. An audit is a well known instrument employed by companies to provide assurance and transmit confidence to users of financial statements. In addition, audit also plays a critical role in facilitating the flow of commerce through the financial markets. The industrial economy is predicated on capitalism, a system that prides itself with best allocation of resources through market mechanism.¹⁷⁶ To efficiently allocate their resources in the highly volatile financial market of today, investors need credible and reliable financial report to make informed investment decisions. This information inevitably comes from the management through the financial report. As seen in chapter I, financial report is, ipso facto, the responsibility of management. Management has the authority to determine its nature and contents. Audit functions as a mechanism to attest to the accountability and stewardship of company management and reinforce trust and confidence in the financial reporting. Thus, it authenticates the appropriateness of the information to users through compliance with relevant laws, regulations and professional code of ethics.¹⁷⁷ As such, users should be able to rely on the information in the audit reports in making investment decisions. However, when a company fails, especially immediately after its public issue of shares, like the case of Enron in the United States or Bankia in Spain, much is left to be desired and undermines the credibility of audit practice. Consequently, the auditing profession that was once highly regarded is now faced with credibility crises and a growing mistrust of its function by the public, widely known as the audit expectation gap.¹⁷⁸ As pointed out by LIMPERG, “audit function is rooted in the confidence that society places

¹⁷⁶ LEE, T. H. & GLOECK, J. D., “The Audit Expectation Gap: An Empirical Study in Malaysia”, *Southern African Journal of Accountability and Auditing Research*, 7, 2007, p. 1.

¹⁷⁷ SALEHI, M. & ROSTAMI, V., “Audit Expectation Gap: International Evidences”, *International Journal of Academic Research*, 1, 2009, p. 140.

¹⁷⁸ This term has been referred to as “Brecha de Expectativas” in the preamble to “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas.”

in the effectiveness of the audit and in the opinion of the accountant...if the confidence is betrayed, the function, too, is destroyed, since it becomes useless.”¹⁷⁹

2. EXPECTATION GAP AND AUDITOR LIABILITY

Auditor's position as an intermediary in an accountability relationship is more frequently being called into question around the world. As HUMPHREY et al. argued, auditor's review of financial statements of companies “has been characterized by a seemingly ever present uncertainty over its purpose, content and effect.”¹⁸⁰ In the twilight of the last century the uncertainty led to dissatisfaction among financial statements users and for similar reasons the auditing profession was forced to endure high levels of litigations and accusations. That being the case, it is reasonable to argue that auditor's liability is inextricably related to the way the society view the role of the auditor. The less understandable the role of the auditor is, the greater the possibility that the society will blame the auditor for corporate failures that affect their investments.¹⁸¹

The criticism of auditors, it is argued, is owed to the fact that many users of financial statements do not seem to understand the nature of audit function.¹⁸² Users take an audit opinion, especially an unqualified opinion, for foolproof financial reporting.¹⁸³ There is also a sense among users of financial statements that auditors apart from giving an opinion should go further and interpret the financial statements to enable users properly evaluate the situation of the company to decide whether or not to invest in the company. There are also users who expect auditors to perform some of the audit procedures while performing the attest function like penetrating into company affairs, engaging in management surveillance and detecting illegal acts and fraud on the part of management.¹⁸⁴ It is these high expectations on the part of users of financial statements

¹⁷⁹ LIMPERG, T. (1933) cited in PORTER, B., SIMON, J. & HATHERLY, D., *Principles of External Auditing*, John Wiley & Sons Ltd., 2005, p. 119.

¹⁸⁰ HUMPHREY, C., MOIZER, P. & TURLEY, S., “The Audit Expectation Gap – Plus C’est la Môme Chose”, *Critical Perspectives on Accounting*, 3, 1992, p. 137.

¹⁸¹ GLOECK, J.D. & DE JAGER, H., *The audit expectation gap in the Republic of South Africa*, School of Accountancy Research Series, University of Pretoria, Research Report 1, 1993, p. 6.

¹⁸² HUMPHREY, C., TURLEY, W. S. & MOIZER, P., “The Audit Expectations Gap in Britain: An Empirical Investigation”, *Accounting and Business Research*, 23, 1993, p. 395.

¹⁸³ SALEHI, M., “Audit Expectation Gap: Concept, Nature and Trace”, *African Journal of Business Management*, 5, 2011, p. 8379, accessed June 12, 2013 at <http://www.academicjournals.org/AJBM>

¹⁸⁴ Id.

that create a gap between auditors and users on the audit function.¹⁸⁵ In addition, as long as users of financial statements place the responsibility for audit expectation gap on the shoulders of auditors, the burden of narrowing this gap must fall primarily on auditors and perhaps other parties involved in the preparation and presentation of financial information.¹⁸⁶

A study of the professional literature reveals that members of the auditing profession have two main points of view regarding the expectation gap.¹⁸⁷ One is that of audit function, they believe most users have poor understanding of the nature of audit and the audit function and, that the expectation users place on them is beyond what is required of them by professional regulations and standards.¹⁸⁸ Some segment of users expects auditors to delve into the company affairs or supervise the management, which is not part of their work.¹⁸⁹ They argue further that several investors expect them to go on and interpret the financial statements to enable them judge whether the company is good for investment. Moreover, even “clean” opinion on the part of auditor does not necessarily mean, per se, that the company is financially sound.

The other point of view regards expectation gap as a natural evolutionary symptom in the development of audit, so long as it serves as a reason for identifying and responding to continually changing and expanding public expectations. The public as the real agent of change, in their disquiet at any abuse, will demand accountability which in turn will force the hands of auditors to change their standards and practice. That is why periods of crises are usually periods of change in auditing standards.¹⁹⁰

It can be seen from both approaches that expectation gap exists. Therefore, in an effort to improve its image, the controlling bodies of auditors embarked on an intensified advertising campaign directed at explaining the limitations of an audit to the public and

¹⁸⁵ SALEHI, M. & ROSTAMI, V., *Audit Expectation Gap*..., op. cit., p. 141.

¹⁸⁶ SALEHI, M., *Audit Expectation Gap: Concept* ..., op. cit., p. 8379.

¹⁸⁷ HUMPHREY, C., MOIZER, P., TURLEY, W., “The Audit Expectation Gap – Plus C’est la Meme Chose?” *Critical Perspectives on Accounting*, 3, 1992, p. 137.

¹⁸⁸ Significant percentages of financial statements users rank detection of fraud as most important objective of an audit. However, detection of fraud as an objective of audit that appears in the early audit literature has now been eroded. See Cohen Commission: Commission on Auditors’ Responsibilities, *Report, Conclusions and Recommendations*, AICPA, New York, 1978, p. xix.

¹⁸⁹ Id. at p. 2

¹⁹⁰ HUMPHREY, C., ET AL., *Audit Expectation Gap – Plus* ..., op. cit., p. 137.

conveying the message that the public has to acknowledge the actual responsibilities of auditors. These are contained in the professions' statements on generally accepted auditing standards. Since the end of the 1980s research projects and research reports have at regular intervals expanded on the subject in the literature.¹⁹¹ But what is clear is that the concept of expectation gap rests to a large degree on public perceptions of the role and function of auditors.

To quote the words of a chartered accountant GASTON:

When it comes to credibility, it is the public's perception that matters. It isn't good enough to claim the public's expectations are unrealistic or its criticisms unfair. An expectation gap exists, and we can't afford to ignore it.¹⁹²

The expectation gap factor is probably the most conspicuous cause of the growing number of court cases against auditors. According to LEE & AZHAM, the "problem reached an unprecedented level as a result of the spectacular fall of well publicized corporations like Enron and WorldCom."¹⁹³ PORTER & GOWTHORPE stress that the recent increase in criticism of and litigations against auditors is due to the failure of auditors to meet society's expectations.¹⁹⁴ Thus, auditors' failure to live up to societal expectations has implicated the notion of audit expectation gap and the attendant auditor liability crises. This fact is reflected by AMHOWITZ in the following words:

In recent years one reads with increasing frequency of a crisis in the accounting profession. Depending on the context, the crisis is characterized as one of professional competence, one of public confidence in the accounting profession or one of the profession's fears about its own vulnerability. Although the emphasis of these three characterizations differs somewhat, they all reflect a single underlying notion – that the public accounting profession is somehow

¹⁹¹ PEAT, MARWICK, MITCHELL & CO. (1984) cited in GLOECK, J. D. & DE JAGER, H., *The Audit Expectation Gap...*, op cit., p. 3.

¹⁹² GASTON, S. J., "The Profession's Future: What's at Stake and What It Will Take", *CA Magazine*, April 1987, p. 39.

¹⁹³ LEE T. H. & AZHAM, M. A., "The Audit Expectation Gap: A Review of the Contributing Factors", *Journal of Modern Accounting and Auditing*, 4, 2008b, p. 30.

¹⁹⁴ PORTER, B. & GOWTHORPE, C., *Audit Expectation-Performance Gap in the United Kingdom in 1999 and Comparison with the Gap in New Zealand in 1989 and in 1999*, The Institute of Chartered Accountants of Scotland Edinburgh, 2004, p.1.

failing adequately to fulfill the role that society has come to expect it. Thus blooms the ‘expectation gap’.¹⁹⁵

3. EVOLUTION OF AUDIT IN SPAIN

In Spain, the history of auditing is relatively short compared to the United States and Britain. The recent past history of Spain is not unconnected for some of the reasons responsible for this difference, uncharacteristic of a great empire or better said reminiscent of a fall from grace of a great empire trying to find its bearing in the 20th century. Spain has had its fair share of turbulent past that hindered its socio-political and economic progress: prominent ones being coup d’état, civil war and a long dictatorship. In short, judged by these standards, Spain has propelled itself, within a single generation, from ruins of war and poverty to the doorstep of modern democracy.

The economic and political environment in Spain during the dictatorship may perhaps help to explain the limited scope of audits. As was widely advertised by the propaganda machine of the regime, General Franco held himself accountable only ‘before God and history’. Therefore, practices of accountability did not fit with the wider societal values enforced by the dictatorship, on the contrary, were perceived as an attempt to erode one of its fundamental principles.¹⁹⁶

Moreover, lack of transparency in the financial market with constant state intervention and poor quality firms were all but a symbol of unreliable market for foreign investment, and knowingly, the foreign investor is a coward who only goes to where his investment is safe. The stock exchange market, thus, had a domestic focus and had become a mere extension of the system of economic autarchy that governed Spain. In such a parochial context, stock market practices – such as audits – simply mimicked the wider societal values of non-accountability.¹⁹⁷

¹⁹⁵ AMHOWITZ, H. J., “The Accounting Profession and the Law: The Misunderstood Victim”, *Journal of Accountancy*, 1987, p. 358.

¹⁹⁶ See CARRERA, N., GUTIÉRREZ, I. & CARMONA S., *Organizational Accountability and Firms’ Chances of Survival: An Empirical Investigation of the Spanish Newspaper Industry (1966–1993)*, Carlos III University Working Paper Series, 1999, (Business Economics).

¹⁹⁷ CARRERA, N., GUTIÉRREZ, I. & CARMONA, S., “Gender, the State and the Audit Profession: Evidence from Spain” (1942-88)”, *European Accounting Review*, 10, 2001, p. 808.

Despite some pieces of legislation implemented in the 1960's towards encouraging audit practice in Spain, auditing remained insignificant in the kingdom due to lackadaisical enforcement. Major organizations like security investment companies, banks, savings banks and credit co-operatives, listed companies and some public organizations like the national railway company are required to audit their annual accounts. However, these regulations were not followed due to poor implementation mechanism. Companies only obeyed them at will.¹⁹⁸

The importance of audit function in Spain of those years can, perhaps, be measured through the size of the "Instituto de Censores Jurados de Cuentas" (ICJCE), the main Spanish accounting professional body. Established in 1943, its membership stood at only 346 by the mid-1960s.¹⁹⁹ The promise of a more broad-based system of financial reporting to cater for the increased user needs was briefly signaled by the revisions to the Spanish Commercial Code "Código de Comercio" (Ccom) and National Chart of Accounts in 1973.²⁰⁰ However, acknowledged vague legal constructions and the continuing absence of public filing requirements for corporate financial statements contributed to their rather limited effect.²⁰¹

Increased economic activities and the influx of foreign capital in the 1960's brought about by the favorable investment conditions in Spain helped to drive the role and expansion of auditing. Invariably this led to more demand for audit services. So by the beginning of the 1980s all the major Big Six (now Big Four) accountancy firms had established presence in Spain and predictably dominated the market. The significance of the multinational audit firms' dominance in Spain was revealed by the report which showed that, in 1990, five of the Big Six firms accounted for nearly 75 per cent of the total audit billings in Spain.²⁰² The auditing services market is also of a distinctly two-tiered nature. A reflection of this can be seen in the audit appointments to the top 250

¹⁹⁸ See GABAS TRIGO, F., "Audit Professionals and Audit Firms in Spain", in GONZALO, J. A., (ed.) *Accounting in Spain*. Madrid: Asociación Española de Contabilidad y Administración de Empresas (AECA), 1992.

¹⁹⁹ GARCÍA BENAÚ, M. A. & HUMPHREY, C., "Beyond the Audit Expectations Gap: Learning from the Experiences of Britain and Spain", *European Accounting Review*, 1, 1992, p. 306.

²⁰⁰ TUA PEREDA, J., "The Legal Framework of Accounting", in GONZALO, J.A., (ed.), *Accounting in Spain*, op. cit., p. 170.

²⁰¹ GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., at p. 307.

²⁰² See Instituto de Contabilidad y Auditoría de Cuentas, Boletín No. 5, 1990.

Spanish companies (excluding banks). No local Spanish audit firm that is independent of the multinational firms has more than one audit brief among this list of companies.²⁰³ Successive years of economic growth and unprecedented influx of foreign investment transformed the Spanish financial market and indeed auditing. According to SALMON, “the most important structural change in the Spanish economy during the 1980’s was the further opening up of the economy to international trade and the avalanche of foreign inward investment occasioned by new legislation and membership of the European Community”.²⁰⁴ These years represented the most rapid and pervasive transformation in the Spanish society, affecting all aspects of life, socio-economic as well as political. For the Spanish people the goal was clear, to seize the most opportune period in their history and gravitationally drive their economic development to the level comparable with their leading European economic partners, and thereby transform the life of their people. Membership of the European Union symbolized for Spain a new era of democracy, good governance and rule of law and above all an acceptance into the fold of the “developed” nations. As JACQUES DELORS, the then EC Commission President noted “in Spain, the idea of the European Community is associated with democracy, justice and progress.”²⁰⁵

The impulse into the European Union was helped by the overwhelming electoral victory of the socialist party, “Partido Socialista Obrero Español” (PSOE) in the 1982 general elections, the first parliamentary majority on Spain’s return to democracy. The socialists were committed to Spain entering into the European Economic Community; a feat duly achieved in January 1986 when Spain was finally admitted into the EU. The implications of Spain’s accession to the EU were very significant for its auditing and company laws because the membership of the European Union required, as a condition precedent, the implementation of various Community regulations, including the company law directives. Work began on a new auditing law in Spain in 1983 and the draft law was passed for debate in Parliament in October 1987.²⁰⁶ The Audit Law, based on requirements of the EC’s Eighth Directive was finally passed in July, 1988,

²⁰³ GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., at p. 306.

²⁰⁴ Id.

²⁰⁵ DELORS, J. (1985) in BOUGEN, P. D. & VAZQUEZ, D., “Debating Spanish Audit Legislation: The Audit Law of 1988”, *European Accounting Review*, 1, 1997, p. 3.

²⁰⁶ RUIZ-BARBADILLO, E., HUMPHREY, C. & GARCIA BENAÚ, M. A., “Auditors versus Third Parties and Others: The Unusual Case of the Spanish Audit Liability “Crisis”, *Accounting History*, 5, 2000, p. 122.

representing the single most important piece of legislation on auditing and financial regulation in Spain.

The new law together with the prospect of belonging to “a league of developed nations” signified by the pending accession to the European Union evoked a sense of revival in Spain. In this environment, audit expectation gap has no significance. Unlike the rather negative image associated with the ‘audit expectations gap’ in countries such as Britain and America in the early 1990’s, Spain in contrast showed a more positive image of auditors as it sought to develop a corporate external audit function.²⁰⁷ This sense of optimism was however not meant to last very long. A few years after the Audit Law came into force Spain was hit by a number of financial scandals that will significantly change public’s attitude towards the role of auditors. The promise and optimism provoked by the Audit Law was soon replaced by talk of audit expectations gap.²⁰⁸

4. GENESIS OF THE AUDIT EXPECTATION GAP CONCEPT

4.1 INTRODUCTION

Auditing in its formative years was almost an absolute assurance against mismanagement and fraud. The simple explanation for this is that businesses then were small in size and had only a handful of employees.²⁰⁹ But as these businesses witness a paradigm shift in their organizational structure and transformed into vast corporations, auditing drifted from verifying all transactions for purposes of fraud detection to determining ‘fairness’ in the financial statements reporting.²¹⁰

This shift, according to IJEOMA, was partly a response to the “growth in volume of business activity (making fraud detection less feasible) and the appearance and increased importance of a new business player in person of the shareholder.”²¹¹ Corporate shareholders and other outside parties increasingly relied on auditors to

²⁰⁷ See GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., p. 312.

²⁰⁸ GARCÍA BENAÚ, M. A., RUIZ-BARBADILLO, E., HUMPHREY, C. & HUSAINI, W. A., “Success in Failure? Reflections on the Changing Spanish Audit Environment”, *European Accounting Review*, 8, 1999, p. 701.

²⁰⁹ SALEHI, M., *Audit Expectation Gap: Concept...*, op. cit., p. 8376.

²¹⁰ IJEOMA, N. B., “Bridging the Expectation Gap in Auditing: The Role of the Accounting Profession in Nigeria”, *International Journal of Technology Enhancements and Emerging Engineering Research*, 2, 2014, p. 120.

²¹¹ Id.

attest and provide assurance on the information prepared by the management.²¹² Hence, audit came to assume essential place in the corporate and financial enterprise. This importance has been underscored by the COHEN Commission thus:

The accounting system and the controls over it are designed to produce proper recording of performance and accountability for the assets entrusted to the entity. Users of financial statements need assurance that management has fulfilled its stewardship responsibility by establishing and supervising a system that adequately protects corporate assets. An audit provides reasonable assurance that management has fulfilled this responsibility.²¹³

A similar sentiment is repeated by the CADBURY Committee as follows:

The annual audit is one of the cornerstone of corporate governance...the audit provides an external and objective check on the way in which financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its objectivity and effectiveness.²¹⁴

Auditing became a condition sine qua non in corporate financing. However, the increase in size and volume of company's transactions made it difficult for auditors to examine every transaction. Therefore the earlier straightforward recognized objective of audit as an instrument for "fraud detection" changed to "verification" of accounts.²¹⁵ Arguably, expectation gap is owed to the fact that users of financial statements have not yet fully adjusted to the change in the objective of audit from 'fraud detection' to 'verification' of account statements.

Complaints about the auditor, his functions in the community, and his responsibilities have been traced as far back as that period.²¹⁶ But the concept "expectation gap"

²¹² This time management of businesses passed from owners to small groups of professional managers.

²¹³ Cohen Commission, 1978, op. cit., p. 5.

²¹⁴ Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), 1992, par. 5.1, accessed April 17 2013 at www.independentdirector.co.uk/cadbury.htm.

²¹⁵ IJEOMA, N. B., Bridging the Expectation ..., op. cit., p. 120.

²¹⁶ HEALY, A. (1991) in GLOECK, J. D. & DE JAGER, H., The Audit Expectation Gap..., op cit. p. 2.

emerged in the 1970's with the first use of the phrase being accredited to LIGGIO, who described it as follows:

The expectation gap stems from differing expectation levels as to both quality and standard of the accounting profession's performance and what it is expected to accomplish.²¹⁷

The phrase was repeated in Cohen Commission, set up in 1974 by the American Institute of Certified Public Accountants (AICPA).²¹⁸ Its history however can be traced back to the 1930's cases of *Ultramares v. Touch Niven & Co.*,²¹⁹ and McKesson and Robbins.²²⁰ The issues canvassed and debated in those cases incorporate audit performance gap with both cases highlighting auditors' failures. Although *Ultramares* was popularly known for third party liability, it is also true that the court did criticize the defendants for failing to distinguish their statement of audit's scope from statement of opinion.²²¹ As a result the accounting profession removed and replaced the word "certify" with "opinion" in audit reports to indicate that audit is just an opinion, not a guarantee. The impressive reflection of CHATFIELD summarizes this position:

His examination of the books was not intended to prove anything, but simply to put his mind in contact with the company's affairs. His knowledge and his skill in applying audit techniques then allowed him to express a professional opinion of management's financial statements.²²²

In an investigation by the SEC committee on the case of McKesson and Robbins to comprehensively overhaul audit priorities, it was concluded that audit standards were inadequate and that the type of audit being performed was not serving even its ostensible purpose.²²³ A situation which led to the following observation by the then AICPA secretary:

²¹⁷ LIGGIO, C. D., "The Expectation Gap, The Accountant's Waterloo?" *CPA Journal*, July 1975, p. 24.

²¹⁸ Cohen Commission, 1978, *supra*. This commission was set up to investigate and come up with recommendations on how to improve the audit environment. Its report was submitted in 1978.

²¹⁹ [1931] 255 NY 170

²²⁰ HUMPHREY, C., ET AL., Audit Expectation Gap – Plus ..., *op. cit.*, p. 141.

²²¹ *Id.*

²²² CHATFIELD, M. A. (1977) in HUMPHREY, C., ET AL., Audit Expectation Gap – Plus ..., *op. cit.*, p. 141.

²²³ *Id.*

We find that the public has believed that the certified public accountant was an infallible superman; that the signature of a CPA invariably meant that everything was perfect; that it was unnecessary to read the accountant's certificate or the financial statements to which it was appended as long as the three major letters were in evidence... Whether through its own fault or not, the accounting profession seems to have been oversold. Its limitations have been overlooked, whilst its abilities have been emphasized. Now the public has been somewhat shocked to find that even auditors can be fooled by clever criminals.²²⁴

A similar concern was expressed by a distinguished professional accountant Carman BLOUGH when he asserted that:

If there occurs any event which tends to shake the public confidence, and if it gains sufficient attention, sooner or later the Government is likely to turn its attention to the problem. Such an unfortunate event occurred during the past year which has resulted in some critical comment regarding auditing procedures. Financial writers, congressmen, reformers, and others, some informed, and some uninformed, some friendly to accountants some unfriendly, have been free with their suggestions and with their criticisms of the public accountants ... The best way that I can imagine to prevent unwise public action is for us to work more energetically in the public interest and at the same time to educate the public to an understanding of what we are doing.²²⁵

4.2 DEFINITIONS

The expectations gap debate is not free from controversy even when it comes to definition. This is due to different meanings attributed to audit by the public and the audit profession.²²⁶ Nonetheless, there are a number of attempts to define the audit expectation gap. In the following paragraphs some of the most relevant definitions will be highlighted. A convenient starting point will be with LIGGIO, who defined audit expectation gap as the difference between the levels of both quality and expected performance 'as envisioned by the independent accountant and by the user of financial

²²⁴ MILLER, R. D., "Governmental Oversight of the Role of Auditors", *CPA Journal*, 1986, p. 35.

²²⁵ BLOUGH, C. G. (1940) in HUMPHREY, C., ET AL., *Audit Expectation Gap – Plus ...*, op. cit., p. 141.

²²⁶ OJO, M., *Eliminating the Audit Expectations Gap: Myth or Reality?* MPRA Paper 232, 2006, accessed October 10 2013 at http://mpra.ub.uni-muenchen.de/232/1/MPRA_paper_232.pdf.

statements.’²²⁷ LIGGIO’s definition of the expectation gap presupposes the difference between the levels of expected performance from the point of view of auditors and the users of financial statements.²²⁸

The Cohen Commission extended the definition of the audit expectation gap mean the difference between the perception of users of financial statements of auditor’s duties and what auditors believe are their real responsibilities.²²⁹ SALEHI envisions the audit expectation as “the gap between the auditor’s actual standard of performance and the various public expectations of auditor performance.”²³⁰ PIERCE & KILCOMMINS,²³¹ on the other hand, are of the opinion that the audit expectations gap is when external auditors’ understanding of their role and duties differ in comparison with the expectations of user groups and the general public. OJO defines audit expectation gap as “the difference between what users of financial statements, the general public perceive an audit to be and what the audit profession claim is expected of them in conducting an audit.” She accordingly emphasized the need “to distinguish between the audit profession’s expectations of an audit on one hand, and the auditor’s perception of the audit on the other hand.”²³²

PORTER, however, noticed that many definitions have failed to take cognizance of the possibility of sub-standard performance by auditors.²³³ She therefore argued that the concept of auditor’s expected performance from LIGGIO’s definition was too vague and that it ignores the fact that auditors, as human beings, do not always behave as prescribed by the professional standards. Consequently, she defined expectation gap as “the gap between society’s expectations of auditors and auditors’ performance, as perceived by society.”²³⁴ She went on and proposed that the gap comprises two major components, namely (a) reasonableness gap (i.e. the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish);

²²⁷ LIGGIO, C. D., *The Expectation Gap*..., op. cit., p. 27.

²²⁸ Id.

²²⁹ Cohen Commission, 1978, op cit., p. xi.

²³⁰ SALEHI, M., *Audit Expectation Gap: Concept* ..., op. cit., p. 8380.

²³¹ PIERCE, B. & KILCOMMINS, M. (1995) cited in OJO, M., *Eliminating the Audit Expectations*..., supra.

²³² Id.

²³³ PORTER, B., “An Empirical Study of the Audit Expectation – Performance Gap”, *Accounting and Business Research*, 24, 1993, p. 50.

²³⁴ Id.

and (b) performance gap (i.e. the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve).²³⁵

In line with PORTER's arguments, HUMPHREY, et al, suggest that a common factor running across various of these definitions is that auditors do not carry out their duties in a manner consistent with the aspirations and desires of the public who also have interest in the audit.²³⁶

4.3 NATURE AND STRUCTURE OF THE EXPECTATION GAP

Several studies have been carried out to gauge the nature of audit expectation gap prevailing in different countries of the world.²³⁷ These studies have also looked at differences in perceptions across the different strata of the society. In the case of US, for example, several governmental and professional investigations have commented on aspects of audit expectations. Prominent among these commissions was the Cohen Commission, a commission set up with the specific task of making recommendations on the appropriate responsibilities of auditors.

BARON et al, on the other hand, conducted a research to determine the extent auditors can go in carrying out their responsibilities of detecting material errors, irregularities and illegality in audit. They tried to establish whether auditors and users of financial statements differ in their perceptions with regards to auditors' duties of detection and disclosure. They found that auditors and users of financial statements have significantly different views and preferences on the extent of auditors' responsibilities for detecting and disclosing irregularities and illegal acts. In particular, users held auditors to be more responsible in detecting and disclosing irregularities in the audit than auditors will ever admit.²³⁸

²³⁵ Id.

²³⁶ HUMPHREY, C., ET AL., Audit Expectation Gap – Plus ..., op. cit., p. 137.

²³⁷ Apart from several studies conducted in the US, the audit expectation gap has been the subject of research in many parts of the world. Studies on the subject have been conducted, for example, by the Canadian Institute of Chartered Accountants, Adams Committee, 1978; HUMPHREY, MOIZER & TURLEY (1992) in the UK; GLOEK & JAGER (1993) in South Africa; GARCIA BENAÚ, ET AL. (1993) in Spain; LOW, FOO & KOH (1988) in Singapore; the Society of Certified Practicing Accountants and the Institute of Chartered Accountants in Australia (1994), TROBERG & VIITANEN (1999) in Finland and IJEOMA (2014) in Nigeria.

²³⁸ BARON, C.D., JOHNSON, D.A., SEARFOSS, D.G. & SMITH, C.H., "Uncovering Corporate Irregularities: Are We Closing the Expectation Gap?" *Journal of Accountancy*, 144, 1977, pp. 243-50.

JENNINGS et al, in their study on auditors' liability contended that auditor liability invariably depends on the way litigants perceive and feel about the auditing profession.²³⁹ In the same vein, LOWE compared the expectations of litigants against that of auditors on the auditing profession. It was found that they have different beliefs on what auditors could achieve in audit, and judges have systematically sided with litigants in urging auditors to do more than auditors believed is statutorily required of them.²⁴⁰

EPSTEIN & GEIGER took a survey of investors to gather information on various aspects of financial reporting, especially, on the level of assurance required of auditors with regards to error and fraud. The data for the study were collected from all the 50 states of the United States through a national survey conducted among the investors representing individuals (not companies). Investors were asked on the level of assurance they believed auditors should provide to detect material misstatements and errors in the financial statements. The researchers initially anticipated a typical response of reasonable assurance. The results however, suggested otherwise with investors seeking very high levels of financial statement assurance, which reveal the existence of expectation gap between investors and auditors on the level of assurance in audit²⁴¹

A feature common to all of these studies was the findings that a gap between performance and expectation did exist, and that this was not just due to ignorance on the part of users of accounting information. Admittedly, the expectation gap may be attributed to difference of perception on what is reasonably expected from an audit, and of the actual quality of the audit work. Cohen Commission, for example, concluded that generally users had reasonable expectations of auditor's abilities and of the assurances they can give. It attributed the expectation gap more to the public accounting profession's failure to react and evolve rapidly enough to keep pace with changing business and social environment.²⁴²

²³⁹ JENNINGS, M.M., RECKERS, P.M.J. & KNEER, D.C., "The Auditor's Dilemma: The Incongruous Judicial Notions of the Auditing Profession and Actual Auditor Practice", *American Business Law Journal*, 29, 1991, pp. 99-125.

²⁴⁰ LOWE, D.J., "The Expectation Gap in the Legal System: Perception Differences between Auditors and Judges", *Journal of Applied Business Research*, 10, 1994, pp. 39-44.

²⁴¹ EPSTEIN, M.J. & GEIGER, M.A., "Investor Views of Audit Assurance: Recent Evidence of the Expectation Gap", *Journal of Accountancy*, 177, 1994, pp. 60-6.

²⁴² HUMPHREY, C., ET AL., Audit Expectation Gap – Plus ..., op. cit., p. 143.

Although a number of explanations for the existence and persistence of the audit expectation gap appear in the literature, references to users' misunderstandings of the role, objectives and limitations of an audit, inadequate audit standards and deficient auditor performance capture the main essence of its causes. This results in users' dissatisfaction with auditor's performance and undermines confidence in the auditing profession and the external audit function.²⁴³ These factors will be further discussed in the course of this chapter.

5. MODERNIZATION OF AUDIT PRACTICE IN SPAIN

5.1 THE 1988 AUDIT LAW

In Spain, the audit law enacted in July 1988 marked the foundation of statutory audit as we know it today.²⁴⁴ The law heralded a new era of transparency and optimism in the Spanish financial accounting industry.²⁴⁵ It provided, for the first time, a greater security for those who deal with companies as well as gave assurance to shareholders and investors. In addition to satisfying the urgent need for credible financial information, the Spanish legislator sought to institutionalize audit practice through the audit law by giving Spanish auditors the competence and recognition enjoyed by their counterparts in countries like the United States and Britain.²⁴⁶

The 1988 audit law contained a number of provisions regarding status and independence of auditors as well as the means of access to the profession. Above all, the law created the ICAC, the equivalent of the Securities and Exchange Commission (SEC) in the US, as a final authority on audit regulation in Spain. However, the real impetus behind audit expansion and growth in Spain did not come from legislation but rather from economic expansion taking place in Spain at that time.²⁴⁷ The audit law only served to provide Spain with a more orderly and enabling business environment.

²⁴³ SALEHI, M., Audit Expectation Gap: Concept ..., op. cit., p. 8382.

²⁴⁴ This law was made as a result of the implementation of the Eighth EC Directive on Company Law.

²⁴⁵ RUIZ-BARBADILLO, E. GÓMEZ-AGUILAR, N. & BIEDMA-LÓPEZ, E., "Auditing Standards and the Expectations Gap: Evidence from Spain", *Int. J. Critical Accounting*, 4, 2012, p. 489.

²⁴⁶ RUIZ-BARBADILLO, E., GÓMEZ-AGUILAR, N., DE FUENTES-BARBERA, C. & GARCÍA BENAÚ, M. A., "Audit Quality and the Going-concern Decision-making Process: Spanish Evidence", *European Accounting Review*, 13, 2004, p. 602.

²⁴⁷ CAÑIBANO, L. & UCIEDA, J. L., *Accounting and Financial Reporting in Spain*, 2005, p. 2, accessed August 11, 2011 at: www.uam.es/~pdi/.../canibano_ucieda_2005.pdf

Perhaps, most importantly, it ushered in a new atmosphere of hope and optimism in Spain, a far cry from the gloomy years of obsolete auditing and accounting framework that had marred audit quality and transparency in the kingdom.²⁴⁸

The law duly established a statutory audit obligation for medium and large limited companies. It also laid down a model stipulating the responsibilities of the audit profession and the way in which it was to be regulated.²⁴⁹ The 1988 Audit Law has far more practical significance, it ‘. . . opened the way to the commercial and accounting law revolution’,²⁵⁰ which subsequently followed, as Spain adapted its national financial reporting practices to the EC’s Fourth and Seventh Directives. The ever present revolutionary nature of the proposed law was also echoed during the parliamentary debates:

The recent integration of Spain within the EEC also advises the development of this transparency in information. Therefore, this law is not only going to fill a gap in our legal system, but will also facilitate better performance by Spanish firms, since it depends on an exact knowledge of their economic and financial situation, and will make possible comparisons with other EEC firms, meaning, after all, a better market economy system.²⁵¹

The spirit of the moment was well captured by IAN GIBSON in the following words:

What most strikes one about Spain, indeed, is its new-found optimism, the growing conviction that at last, after centuries of instability, isolation, coups d’état and civil wars, there is now a good chance that sustained progress may be possible within the stable framework of the EC. That a great deal remains to be done, particularly to reduce social injustice, few would deny; but the will to do it is there.²⁵²

²⁴⁸ GONZALO, J. A. & GALLIZO, J. L. (1992) in GARCIA BENAÚ, M. A., ET AL., *Success in Failure...*, op. cit., p. 703.

²⁴⁹ Id.

²⁵⁰ CASANOVAS PARELLA, I., “Spain and the Process of Harmonization with EC Regulations”, in GONZALO, J.A., (ed.), *Accounting in Spain*, op. cit., p. 173.

²⁵¹ Congreso de los Diputados, Proyecto de Ley No. 53.1, p.1, 22 October 1987

²⁵² See GIBSON, I. (1992) cited in GARCIA BENAÚ, M. A., ET AL., *Success in Failure...*, op. cit., p. 703.

For the Spanish economy, the new legal environment represents a bridge to a future of stability and prosperity. As noted by RUIZ-BARBADILO et al. “the new legal establishment of auditing in Spain was accepted by society in general with much enthusiasm, as auditing was considered to satisfy an urgent need in the modernization of the national economy.”²⁵³ This was followed by the commercial law of 1989, which requires the public filing of company financial statements. The Spanish business environment had never been better. The frequently expressed view then was that the EC-inspired legislations were set to provide Spain with a more orderly and equitable business environment, with less corruption and more reliable financial information. Empirical surveys of the time show only limited evidence of the type of expectations gaps that have traditionally characterized the statutory audit function in countries like the United Kingdom and the United States,²⁵⁴ notwithstanding the fact that auditing services market is dominated by the very same firms whose performance has been the focal point of debate in the US and other Anglo-Saxon countries. In Spain the audit environment paints a favorable image representing opportunity and modernity.²⁵⁵

The general view was that Spain was set to move away from the conspicuous traditions, like manipulation of financial reports for tax evasion that had characterized the management and reporting of corporate financial affairs in the country.²⁵⁶ In fact, such views even go beyond the auditing profession, with commentaries in the financial and academic accounting press frequently referring positively to recent audit and accountancy legislation. Auditing in Spain represented not a gloomy atmosphere of unmet audit expectations and questionable financial reporting practices that sometimes characterized the United States’ audit environment but a current economic reality and promise of a better future. These sentiments were expressed by various observers in these words:

Auditors have been the voice of conscience of institutions and companies, and the collaborators involved most closely in the attempts that have been undertaken to modernize the state of accounting information.²⁵⁷

²⁵³ RUIZ-BARBADILO, E., ET AL., *Audit Quality...*, op. cit., p. 603.

²⁵⁴ RUIZ-BARBADILLO, E., ET AL., *Auditors versus Third Parties...*, op. cit., p. 128.

²⁵⁵ GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., p. 312.

²⁵⁶ Id. at p. 311.

²⁵⁷ Id. at p. 312.

The introduction of modern criteria for the preparation of accounting information, such as the concept of the true and fair view and the audit and publication requirements is a radical change from previous practices. Although Spanish companies will go through a period when there are adjustment problems, we believe that there are objective reasons for optimism.²⁵⁸

The objectives of the Spanish mercantile reforms could not suitably be attained without having established the general obligation to submit (corporate) financial information to audit by an independent expert, as a way of guaranteeing the protection of the interests of third parties related to the company.²⁵⁹

We consider that the audit obligation and the publication of annual financial statements will make it possible for business accounting information systems to be much more transparent than at present and will provide a greater impulse for the long-desired accounting reform, so as to achieve a situation in which the formal appearance and the economic and financial reality of the reform coincide.²⁶⁰

5.2 ENTER THE EXPECTATION GAP IN SPAIN

The enthusiasm and public optimism ushered in by the Spanish financial reforms took a bad turn by the mid-1990s, as a string of major corporate failures repeatedly questioned the ‘New Spain’ euphoria and made it look like a fairy tale. No case highlighted the apparent failure of Spain to break away from its yesteryears of poor accounting tradition than the case of Banesto.²⁶¹ The Banesto debacle, reminiscent of the recent Bankia scandal, involves fraud and falsification of accounting document by top management with acquiescence of its auditors. The audit profession, which had at one stage looked so positive, and comfortable with the plaudits and high expectations being lauded on it,²⁶² must now respond to the public on what went wrong or whether the public trust it enjoyed was misplaced? Subsequent by the Spanish Central Bank investigators only

²⁵⁸ CONDOR, V., “The Impact of EC Directives on Spanish Accounting Law, With Special Reference to Group Accounts”, *European Accounting*, 1991, p. 38.

²⁵⁹ TUA PEREDA, J., “La Reforma del Ordenamiento Jurídico Mercantil en Materia de Información Financiera”, *Revista Técnica*, 1990 at p. 17.

²⁶⁰ See GONZALO, J.A., (ed.), *Accounting in Spain* op. cit., p. 183.

²⁶¹ GARCIA BENAÚ, M. A., ET AL., *Success in Failure...*, op. cit., p. 702.

²⁶² Id.

confirmed the public's worst fears of corruption and insider-dealings at the highest level. These revelations increased the public doubt over the audit function and auditors' capacity to serve their interest. The romance between the public and auditing profession seems to be over.

The audit profession however appeared much more defensive on its response than remorseful. Like their counterparts in the United States, they responded that the audit expectation gap was because of ignorance of the nature and function of audit by the public. In fact, the auditing profession in Spain thought they were just victims of unfortunate corporate scandals.²⁶³ The words of JESÚS PEREGRINA summarize auditors' sentiments:

The auditor is not God at the time of signing his report. The job of the auditor is to affirm the financial statements at a time determined by the company. One cannot expect [auditors] to have a crystal ball with which to predict the future, although one could ask them to get sufficient information to make a prognosis more quickly in serious cases. And neither could one ask them to detect frauds and illegal operations if these actions are supported by corresponding receipts.²⁶⁴

What was surprising about the Banesto debacle was the fact that the bank was closely monitored by the Bank of Spain with its inspectors been ever-present in Banesto because of its pending public offer. Banesto's 1992 accounts were also duly audited and certified by its auditors, Price Waterhouse, without any adverse qualification. But six months after the public issue of its shares, the most successful in Spain's history and approved by the Bank of Spain, a deficit of 605,000 million Pesetas emerged from its accounts. Explanation to the Banesto situation remained suspect to the public with ripe rumors of witch-hunt and political machination. But as observed by John Hooper:

No matter which way you read the Banesto affair, one of its messages is: 'Foreign investors beware'. . . . Now, either J. P. Morgan was right in thinking

²⁶³ RUIZ-BARBADILLO, E., ET AL., Auditing Standards..., op. cit., p. 489.

²⁶⁴ JESÚS PEREGRINA, the then President of both KPMG Peat Marwick, Spain, and the "Instituto de Auditores Censores Jurados de Cuentas" (IACJC), quoted from *El Mundo*, July 16, 1994 by GARCIA BENAÚ, M. A., ET AL., Success in Failure..., op. cit., p. 702

Banesto could be saved (in which case the Bank of Spain intervened unnecessarily), or Mr. Rojo was right in thinking it was doomed (in which case J. P. Morgan made a serious misjudgment when they bought into it so heavily last summer). Whichever way, the implications for foreign investors are disturbing. If the Spanish authorities intervened unnecessarily, it raises a suspicion they were playing politics with the economy – pouncing on an opportunity to discredit an enemy and critic. Mr. Conde had long been at loggerheads with the Socialist government and was suspected of nurturing political ambitions. He had bought heavily into the media. If, on the other hand, J. P. Morgan made a mistake, it raises questions about the accuracy of the accounts that were made available to the Americans. Neither suspicion reflects well on Spain as a home for foreign capital. The first implies a country in which the authorities are prepared to skew the operation of a free market in order to settle a grudge. The second suggests one in which the business culture is so opaque it cannot be read, even by one of the world's most renowned financial institutions.²⁶⁵

As seen in the above case, very high expectations have been dampened as a result of those corporate scandals. Consequently, substantial fines had been imposed on a number of the major international audit firms by the Spanish audit regulatory body, the ICAC, for inadequate auditing.²⁶⁶ Nonetheless, the response by the Spanish auditing profession had been defensive when questioned on their role leading up to the scandal and issues relating to regulation of auditing. They pointed to public misunderstandings of what can reasonably be expected of the auditor, emphasizing the significant responsibilities of company management with respect to the prevention of fraud. They particularly see the Spanish regulatory body, ICAC as interventionist that needs urgent change. The ICAC's licensing and sanctioning powers was clearly disliked by the profession.²⁶⁷

265 See The Guardian, January 8, 1994.

266 RUIZ-BARBADILLO, E., ET AL., Auditing Standards..., op. cit., p. 489.

267 RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 121.

6. FACTORS RESPONSIBLE FOR AUDIT EXPECTATION GAP

6.1 INTRODUCTION

The overall conclusion to be drawn from the above review of professional and governmental investigations over the last three decades across different countries is that the expectations gap appears to be a persistent problem. In addition, whilst the expectation may be partly blamed on the evolutionary changes in the auditing environment over time, it is entirely reasonable for users of auditing services, as primary beneficiaries of the audit process, to expect the auditor to deliver quality service including warning signals when necessary. If they feel that good work has not been delivered by the audit, they become suspect which in turn contributes to the persistence of the expectation gap.²⁶⁸ In the following paragraphs, questions concerning the factors responsible for the persistence of the expectations gap shall be addressed.

As with the definition of expectation gap, there are different explanations offered for the continued presence of the expectation gap problem. For example, LEE & AZHAM in their study of the factors contributing to the existence of the audit expectation gap identified, among other factors, the “complicated nature of an audit function; conflicting role of auditors; retrospective evaluation of auditors’ performance; time lag in responding to changing expectation; and self-regulation process of the auditing profession” as prominent reasons for continued existence of the audit expectation gap.²⁶⁹ An outline of these factors will be attempted below.

6.2 IGNORANCE OF AUDIT FUNCTION

The general public’s poor understanding of the complicated audit function has been identified as a likely factor that contributes towards the existence of an audit expectation gap.²⁷⁰ According to LEE & AZHAM, “the complexity of auditing could be due to the fact that the objective of auditing and the role of auditors have always been a dynamic rather

²⁶⁸ AQUILA, A., ET AL., (1992) in GLOECK, J. D. & DE JAGER, H., “The Audit Expectation Gap in the Republic of South Africa”, School of Accountancy Research Series, Research Report, University of Pretoria, 1993, p. 9.

²⁶⁹ LEE, T. H., & AZHAM, M. A., “The Audit Expectation Gap: A Review of the Contributing Factors”, *Journal of Modern Accounting and Auditing*, 4, 2008b, p. 30.

²⁷⁰ Id.

than a static one.”²⁷¹ Auditing, inevitably, has been affected and influenced by the socio-economic circumstances obtained at a given period of time and place in history, like the collapse of big corporations, the verdict of the courts, and technological developments. Therefore, any major changes in these contextual factors are likely to cause a change in the auditing function as well as the role of auditors.²⁷²

The complicated nature of audit function can also be seen by a change in the auditing paradigm over the years. According to LEUNG, et al. the audit practice for centuries had undergone various changes.²⁷³ For example, in the mid 1800s to early 1900s an auditing function can be regarded as “traditional conformance role of auditing,” which signifies that auditors then had to ensure that statements of accounts are correct as well as free from frauds and errors. Over the past 30 years or so, the auditor only plays an “enhancing role” by enhancing the integrity and credibility of the financial information which, in ordinary language, means that fraud detection is no longer the main objective of audit.²⁷⁴

Obviously, given the substantial changes that audit practice had undergone over the years, it is to be expected at a certain point that the public may be confused about the essence of an audit. In addition, there are some arcane terms used in audit like true and fair view, reasonable, materiality, adequacy, reliability and relevance, which are amenable to subjective interpretation and are at best confusing even to the reasonable man.²⁷⁵ For instance, the ombudsman term “true and fair” used in the audit reports has still defied precise definition which does not help in easing the users’ understanding of audit. LEE & AZHAM further argue that because most of audit terms and concepts are not well defined, in applying these terms auditors usually resort to the exercise of individual judgment and “given the complicated nature of auditing and the objective of an audit, confusion is likely to exist among those who have limited knowledge and exposure in auditing.”²⁷⁶

²⁷¹ LEE, T. H. & AZHAM, M. A., “The Evolving Role of Auditor: Where Do We Go from Here?” *Accountants Today*, 2008a, p. 21.

²⁷² LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 30.

²⁷³ LEUNG, P., ET AL. (2004) in LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 31.

²⁷⁴ Id.

²⁷⁵ HUMPHREY, C., *Debating Audit Expectations* in SHERER, M. & TURLEY, S., (eds.), *Current Issues in Auditing*, 1997, London: Paul Chapman Publishing Ltd.

²⁷⁶ LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 31.

6.3 CONFLICTING ROLE OF AUDITORS

Users of financial statements view the provision of consultancy services by the same audit firm as an imminent area of conflict of interest and at best a bad incentive for independence. Accounting firms have over the years diversified by providing a wide range of services and products which include engagements for risk assessment, business performance measurement, information reliability systems, and electronic commerce among others.²⁷⁷ A study in the US revealed that accountants have become increasingly dependent on consulting.²⁷⁸ In 2001, for instance, PricewaterhouseCoopers earned only 40% of its worldwide fees from auditing, 29% came from management consulting and most of the rest from tax and corporate finance work.²⁷⁹ Auditors' multiple role is seen to have negative implications on the auditor's ability to perform a fair audit, as they are likely to compromise and yield to the management's pressure in order to protect their lucrative consultancy services. A similar conclusion was reached by users of financial statements in Spain in a 2004 study.²⁸⁰

6.4 RETROSPECTIVE EVALUATION OF AUDITORS' PERFORMANCE

The society usually is incapable of determining the quality of an audit and performance of auditors till after the occurrence of an event, like corporate failure. Thus, whenever a financial scandal strikes the news headlines, the public suspect's lack of sufficient diligence on the part of auditors. According to SHAKED & SUTTON, this is due to the fact that the public have difficulties in comparing between one audit and another.²⁸¹ In a similar vein, HUMPHREY et al. argue that any after the fact judgment through hindsight evaluation of auditors is unfair. They further emphasized that hindsight assessment of audit quality is based on after the fact knowledge that may be, at times, unpredictable.²⁸² Criticism through hindsight was lamented by the former AICPA vice-president as part of auditors' life:

²⁷⁷ Id.

²⁷⁸ Id.

²⁷⁹ Id.

²⁸⁰ ANTONIO, M. V. & PUCHETA, M. C., "La Independencia de los Auditores de Cuentas Españoles Vista por los Propios Auditores y Algunos Usuarios", *Quehacer Científico*, No. 1, Vol. 1, Enero- Marzo del 2004.

²⁸¹ SHAKED, A. & SUTTON, J. (1982) in LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 32.

²⁸² HUMPHREY, C., ET AL., *Audit Expectation Gap – Plus...*, op. cit., p. 137.

As long as investors suffer losses from a sudden and drastic drop in earnings or the bankruptcy of a corporation which was widely regarded as a good investment, our profession is going to be criticized in the new media. And since such situations are not likely to disappear completely, we ought to become more mature in our reactions to criticisms and recognize that this is an inescapable part of our life.²⁸³

Through hindsight evaluation, auditors have found themselves to be targets of negative publicities even when it is known that they are not to shoulder all the blame all the time. Many reasons could lead to the fall of a corporation, like mismanagement, bad strategic decisions, industry downturns, competition, and poor oversight by boards of directors or fraud by senior managements among others.²⁸⁴

6.5 TIME LAG IN RESPONDING TO CHANGING EXPECTATIONS

Auditors must be conscious of the ever changing times technology had thrust upon them and react accordingly. According to the Cohen Commission, users generally have reasonable expectations of auditor's abilities and of the assurances they can give.²⁸⁵ The Commission therefore attributed the expectation gap much to the public accounting profession's failure to react and evolve rapidly enough to keep pace with changing business and social environment.²⁸⁶ As it is usual with the accounting profession, whenever there is a financial or corporate scandal, it comes up with new or revised accounting standards. This, according to TRICKER, suggests that the accounting profession is gradually and constructively responding to the changing expectations of society.²⁸⁷ TRICKER's assertion was, perhaps, understandable through the actions taken by the AICPA (Auditing Standards Board) as a result of the financial scandals in the 80's and the successive Statements on Auditing Standards issued since then.

²⁸³ OLSON, W. E. (1993) cited in LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 32.

²⁸⁴ PHELON, R. & VILLAREAL, G., "Issues in Accountant Liability Litigation arising from Business Failures", Texas Trial Lawyers Association Commercial Litigation Seminar, Dallas, Texas, 2006, p. 1, accessed on January 8, 2012 at <http://www.bakerbotts.com/.../Accountant%20Liability,%20Phelan%20and%20Villareal.pdf>.

²⁸⁵ Cohen Commission, 1978, op. cit., p. xii.

²⁸⁶ Id.

²⁸⁷ TRICKER, T. (1985) in HUMPHREY, C., ET AL., *Audit Expectation Gap – Plus...*, op. cit., p. 138.

Nonetheless, this effort has been criticized for not going far enough in keeping pace with the rapidly changing audit environment.²⁸⁸

6.6 SELF-REGULATION PROCESS OF THE AUDITING PROFESSION

The self-regulated framework usually in form of professional organization is blamed for been reluctant to enforced regulatory standards.²⁸⁹ SHAKED & SUTTON pointed out that the rationale for self-regulation by a profession is premised on the ground that service quality may be maintained through self-review or other mechanism by the same professionals when the consumers (i.e. audit beneficiaries) are unable to measure the audit quality themselves.²⁹⁰ The shortfall of this arrangement was highlighted by HUMPHREY, et al. in the following words:

The audit profession is not regarded as selfless, neutral body, responding diligently to the changing dictates and expectations of society. Rather, it is seen in a more proactive, economically interested light, needing to maintain the appearance of independent, highly technically competent individuals in order to defend and advance its members' interest. Symbolic traits of independence, trustworthiness, altruism and expertise are viewed as professional mystiques that together with the existence of a professional monopoly of labor give rise to a mutually dependent relationship with the state and serve to enhance the remuneration of members of the profession.²⁹¹

The self-regulated framework is seen as a means used by the accounting profession to retain and maintain a considerable power to itself and to keep within its control the fortunes of its members. MITCHELL argued in the same vein, albeit, without reservation in his condemnation of the disciplinary process under the self-regulation framework:

The profession's disciplinary procedures are even more feudal. Occasionally, in secret meetings, from which its own membership, press and public are excluded, it suspends some individuals from membership....And what about the big fish?

²⁸⁸ LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 33.

²⁸⁹ This has now been overtaken by the Sarbanes-Oxley Act which created a semi-state controlled body.

²⁹⁰ SHAKED, A. & SUTTON, J. (1982) in LEE, T. H. & AZHAM, M. A., *The Audit Expectation Gap...*, op. cit., p. 33.

²⁹¹ HUMPHREY, C., ET AL., *Audit Expectation Gap – Plus...*, op. cit., p. 138.

To date, no partner from any major firm has ever been barred from practice by the Institute, even though the same firm has been criticized by the DTI inspectors again and again...The Institute is completely dominated by the interests of major firms and their financial might.²⁹²

Finally, with little to fear from the flawed disciplinary process of the self-regulatory framework, auditors capitalize on that to deliver a minimum level of service quality to their clients and by extension to users of financial statements. Naturally, this is likely to be in contrast with the expectation of the public who will expect auditors to act more in accordance with the spirit of the auditing professional standards than following the letter of the law. Only by so doing will auditors provide a good auditing service and better accountability of their performance. Anything short of that only confirms the thesis of GLOECK & DE JAGER that “the process of self-regulation and its attendant factors contributes materially to enlarging the expectation gap.”²⁹³

6.7 THE UNREASONABLE EXPECTATIONS

Although users of financial statements generally have reasonable expectation of auditors, many users at times appear to exaggerate the work of auditors. These users usually consider an auditor’s report to be a clean bill of health. This high expectation, according to HUMPHREY, et al. is associated with the problem of misconception of the nature, purpose and capacities of an audit function.²⁹⁴ This situation is sarcastically set out by TWEEDIE as follows:

...the public appears to require (1) a burglar alarm system (protection against fraud) (2) a radar station (early warning of future insolvency) (3) a safety note (general reassurance of financial well-being) (4) an independent auditor (safeguards for auditor independence) and (5) coherent communications (understanding of audit reports).²⁹⁵

²⁹² MITCHELL, I., “Accountability is the Key”, *Certified Accountant*, 1990, 1 at p. 21.

²⁹³ GLOECK, J. D. & DE JAGER, H., *The Audit Expectation Gap...*, op cit., p. 12.

²⁹⁴ HUMPHREY, C., et al. (1993) in LEE, T. H. & AZHAM, M. A., 2008b, op. cit., p. 35.

²⁹⁵ TWEEDIE D., “Challenges Facing the Auditors: Professional Fools and the Expectation Gap”, *The Deloitte, Haskins and Sells Lecture*, University College, 1987, p. 20.

This misconception often leads to unreasonable expectations being imposed on the duties of the auditors. Moreover, it has harmful implications on the audit profession as the public may not be able to recognize the contribution of auditors to society and hence remain unsatisfied. Given that public auditing is meant to inspire confidence any dissatisfaction “is detrimental to the auditing profession as it has negative influences on the value of auditing and the reputation of auditors in the modern society.”²⁹⁶

6.8 CONCLUSION: BRIDGING THE GAP BY STATUTORY MEANS

To address the issue head on, in 1985, the ASB began a series of studies in an attempt at closing the gap between public expectations and the auditor’s professional requirement as enshrined in generally accepted accounting principles. Eventually, these studies were combined into the “expectations gap” project and resulted in the issuance of Statements on Auditing Standards, (SAS). Succinctly, Statements on Auditing Standards, (SAS) are statements issued by the AICPA’s Auditing Standards Board from time to time, and are considered as interpretations of how the 10 GAAS statements should be understood and applied. Through these SAS the auditing profession assumed the responsibility for evaluating and reporting on material uncertainties, including a company’s ability to remain a going concern. Since then, the AICPA has been issuing Statement on Auditing Standards with the aim of bridging the expectation gap between what financial statement users believe auditors are responsible for and what auditors are ready to accept as their responsibility.

7. THE EFFECT OF AUDITING STANDARDS ON EXPECTATION GAP

7.1 THE CONFLICTING VIEWS

The above mentioned studies on expectation and performance gap of auditors did not only conclude that such a gap exists but also emphasized the responsibility of auditors in bridging that gap. This responsibility has been described in a similar fashion by the Cohen Commission as follows:

²⁹⁶ LEE, T. H. & AZHAM, M. A., The Audit Expectation Gap..., op. cit., p. 36.

The burden of narrowing the gap between performance and expectations falls primarily on auditors and other parties involved in the preparation and presentation of financial information.²⁹⁷

The remainder of this chapter will appraise the importance of audit standards in changing auditors' behavior with greater attention to the recent debate about audit expectation gap generated by the well publicized corporate failures that had affected a better part of the industrialized world. In the wake of these bankruptcies, "public criticism of auditors has focused on not only their responsibility for fraud, but also their responsibility to issue a going-concern opinion when a business is about to fail."²⁹⁸ The magnitude of the scandal can only be measured by the symbolism and reach represented by the fall of Enron and Arthur Andersen in the United States and Ahold, among others in Europe.²⁹⁹

Many have asked why auditors did not raise any alarm in the events leading up to these failures. In addition, most of these companies announced bankruptcy soon after receiving an unqualified opinion from their auditors. This fact increased public suspicion of the accounting profession, especially its inability to raise a 'red flag' about the possibility of business failure. These and other events prompted a global race to change audit laws, regulations and standards. The following paragraphs will examine the effects, if any; these changes have in the performance of the auditor.

There are different points of view on the role audit regulation plays and the manner it may contribute to reduce the expectation gap. This is reflected in different approaches to auditing. The first point view represented by MAUTZ & SHARAF, which is forward looking, contends that any auditing standards and regulations implemented should be in the interest of society.³⁰⁰ The more critical perspective, on the other hand, is of the view that auditing and accounting regulations are self-serving. They argue that audit standards are mere public relations tools employed by auditors to give users of audit

²⁹⁷ Cohen Commission, 1978, op. cit., p. xi

²⁹⁸ AKERS, M. D., MAHER, M. A. & GIACOMINO, E., "Going-Concern Opinions: Broadening the Expectations Gap", *CPA Journal*, 2006.

²⁹⁹ Other examples of these scandals included the Parmalat case in Italy, the Maxwell case in the UK, the Flowtex case in Germany, the Vivendi case in France as well as the Baan case in the Netherlands.

³⁰⁰ MAUTZ, R. K. & SHARAF, H. A., (1961) in RUIZ-BARBADILLO, E., ET AL., *Auditing Standards...*, op. cit., p. 484.

reports the impression that they act on their behalf, but in reality these standards only benefit auditors not the society.³⁰¹ However, since the effect of auditing standards may have on reducing the audit expectation gap can only be measured empirically; this thesis will look at some studies conducted to evaluate the impact of new auditing standards on auditors' performance in the United States as well as in Spain.

7.2 PERFORMANCE RATE STUDY IN THE UNITED STATES

For empirical study on auditors' performance rate in the United States, this thesis uses a research conducted by RYU et al. to compare the performance of audit firms for three different periods of SAS No. 34 issued in 1981 and SAS No. 59 issued in 1988 and post-SOX period.³⁰² This study, therefore, examines how these interpretations of GAAP issued by the ASB influence auditors' considerations in classifying companies as going concerns over these periods and which one made the most impact. Preliminary result of the research found that there was no significant difference in auditors' audit accuracy between the SAS No. 59 and post-SOX period, although there was important difference between the SAS No. 34 and No. 59 periods. RYU et al. finding reveal that in post-SOX period; the accuracy rate of audit opinion issued by auditors on a going-concern reached a 44.4% accuracy rate i.e. 8 out of 18 bankrupt clients.³⁰³ They contend further that during the SAS No. 34 and No. 59 periods, the accuracy rates were 40.7% and 51.9%, respectively. They however, cautioned that this result is by no means a definite reason to conclude that the changes in auditing standards provoked by the SOX had no effect on auditor' opinion given the small sample size of only 18 bankrupt firms.³⁰⁴

According to RYU et al., the study took the form of a search of the *Wall Street Journal Index* for firms that went bankrupt in the years 1985–1997 and 2004–2006 under the heading “Bankruptcies.” Then, to find audit opinions, they examined annual reports issued within 15 months prior to filing for bankruptcy. They initially gathered more

³⁰¹ Id. See also PUXTY, A., SIKKA, P. AND WILLMOTT, H., “Mediate Interest: the Accounting Bodies' Responses to the Mcfarlane Report”, *Accounting and Business Research*, 27, 1997.

³⁰² RYU, T. G., ULISS, B. & ROH, C., “The Effect of the Sarbanes-Oxley Act on Auditors' Audit Performance”, *Proceedings of the 2006 Academy of Business Administration Conference*, Journal of Finance and Accountancy, 2006, pp. 1-7.

³⁰³ A going concern is a term of art used in accounting circle to indicate that a certain business under consideration functions well does not face the threat of liquidation in the foreseeable future.

³⁰⁴ Id. at p. 3.

than 300 firms from the *Index*, but because of unavailability of auditors' opinion, about 93 firms were deleted leaving the researchers with 207 sample firms.³⁰⁵

The research came up with result of auditors' accuracy rate of only 40.7% of accuracy, i.e. 11 out of 27 bankrupt firms received a qualified opinion during the SAS No. 34 period. This result was significantly improved after SAS No. 59 became effective. Bringing auditors' accuracy rate to 51.9% of the qualified opinions they issued on bankrupt firms.³⁰⁶

In the same study, a review of the accuracy rate between the SAS No. 34 and No. 59 periods for both the so-called Big 6 (now 4) and other firms indicated to the same tendency, i.e. that there was a significant difference in accuracy between the two periods. The result showed that auditors' accuracy rates greatly improved after the issuance of SAS No. 59, from 43.5% to 52% for Big 6 firms and from 25.0% to 50.0% for Non-Big 6 firms. However, in the post-SOX period, the result showed a diminishing accuracy rate. Of the 15 firms audited by the Big 4 audit firms, only 6 were issued going-concern opinions, representing accuracy rate of 40.4%, but because of the small sample size of the firms involved in the study, the result cannot say anything conclusive about the SOX effect.³⁰⁷

This result, according to RYU et al., may be attributed to the fact that under SAS No. 34, *The Auditor's Consideration When a Question Arises about an Entity's Ability to Continue in Existence*, issued in 1981, in which an entity's continuation was usually assumed, and substantial doubt alone did not warrant going-concern qualification. Instead, substantial doubt about continued existence only led auditors to perform more procedures in order to evaluate the recoverability of assets and the amount and classification of liabilities. Thereafter they are required to give a qualified audit report if they still have doubt about assets and liabilities. In contrast, under SAS No. 59, substantial doubt is now in itself sufficient to require an explanatory paragraph in the

³⁰⁵ Id. at p. 2.

³⁰⁶ Id.

³⁰⁷ Id. at p. 5.

audit report, i.e. without even the necessity of looking at the possibility of asset recoverability and liability amounts and classification.³⁰⁸

In other words, SAS No. 59 affirmatively imposed responsibility upon the auditor to evaluate, in every engagement, the assumption that the audited company can continue as a going concern.³⁰⁹ In contrast, SAS No. 34 required the auditor to assess going concern only when contrary information came to the auditor's attention. Thus, SAS No. 59 increased the auditor's responsibility for detecting firms displaying characteristics that raise substantial doubt about the firm's ability to continue in its existing form for at least one year from the financial statement date. As ELLINGSEN, et al. argue, SAS No. 59 expands the auditor's traditional boundary in reporting on the entity's ability to continue in existence beyond the effect on assets and liabilities.³¹⁰

The clear motive behind SAS No. 34 and SAS No. 59 as well as the post-SOX standards was to close the gap between public expectations of the auditor's responsibility and the auditor's service level as prescribed in the generally accepted accounting principles. But what singles out the post-SOX period, was "the increased risks associated with auditing and the sustained negative publicity about auditors in the media, auditors are now expected to use even more vigorous processes and more conservative steps in deciding whether to issue going-concern or other qualified opinions than they used previously."³¹¹ But the result shows the contrary. Whilst the accuracy rate (51.9%) recorded in the aftermath SAS No. 59 was higher than the rates reported by any previous research conducted before SAS No. 59 became effective, the accuracy rate recorded in the post-SOX period was a far cry from that. In fact the result indicates that the accuracy rate went back down to below 50%, a clear retrogression from the SAS No 59 levels.³¹²

³⁰⁸ Id.

³⁰⁹ The auditor's report, presumably not only points to the financial state of a company but it also "plays a critical role in warning market participants of impending going concern problems. Indeed, the term audit failure typically refers to cases in which auditors fail to issue going concern opinions to clients that subsequently file for bankruptcy" DEFOND, M., et al. contended. See DEFOND, M., RAGHUNANDAN, K. & SUBRAMANYAN, K., "Do Non-Audit Services Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions", *Journal of Accounting Research*, 40, 2002, p. 1254.

³¹⁰ ELLINGSEN, J. E., ET AL. (1989) in RYU, T. G., ET AL., *The Effect...*, op. cit., p. 2.

³¹¹ Id. at p. 3.

³¹² Id. at p. 4.

However, because of the small sample size involved as well as the relatively short period of application of the post-SOX audit standards, RYU et al noted that, it may be premature to draw a clear conclusion from the result. Ultimately, they concluded that more comprehensive research on the subject using more sample firms may be necessary in the future. Meanwhile, they emphasized that the primary objective of this study of providing the basis for evaluation of auditors' performance has been accomplished by the result, which indicates no significant difference between the pre and post Sarbanes-Oxley audit opinions.³¹³

7.3 THE SPANISH CONTEXT

7.3.1 AUDITING STANDARDS IN SPAIN

The study of a going concern opinion in Spain is interesting because of cultural differences and its relatively short auditing tradition in comparison with countries like the United States and Britain. One discernible peculiarity of the Spanish audit market is its lack of market-based institutional incentives like loss of reputation and litigation costs that outweigh economic dependence and promote auditor independence.³¹⁴ In audit markets like the United States and Britain failure to issue a going-concern opinion to a deserving company can harm the auditor's reputation. But in case of Spain, empirical evidence shows that when it comes to auditor choice fees are the most important consideration above other factors like audit quality and auditor reputation.³¹⁵ Another important factor worthy of note in the Spanish context is the low risk of litigation faced by auditors. Until very recently, third party liability of auditors is almost non-existent in Spain and no audit firm has suffered damages to third parties.³¹⁶ The peculiarities that the Spanish context brings to the expectation gap debate make an exciting comparison.

As indicated above, in Spain, the audit expectation gap phenomenon came as a bolt from the blues because it happened only a few years after coming into effect of a much

³¹³ Id. at p. 7.

³¹⁴ RUIZ-BARBADILLO, E., ET AL., Audit Quality..., op. cit., p. 604.

³¹⁵ Id. For a general look at the subject, please see also GARCIA BENAÚ, M. A., RUIZ-BARBADILLO, E. & VICO MARTINEZ, A., "Factores que condicionan la elección y el cambio en la empresa española", *Revista de Contabilidad*, 3(6), 2000, pp. 49–80.

³¹⁶ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 121.

celebrated audit regulation.³¹⁷ With little or no auditing tradition at that time, Spain had no precedence to follow or any specific auditing standard on going concern evaluation. Even the Audit Law did not make specific provision regarding any obligation on the part of auditors to evaluate their client's risk of bankruptcy.³¹⁸ Although such responsibility may be implied from the provision of article 5 of "Ley 22/2015", which requires auditors to give their opinion if the non-application of any accounting principles has affected the elaboration of the audit report in any way.³¹⁹ Another law that requires auditors to assess company's risk of failure is "Ley de Sociedades de Capital."

Under its articles 262 and 263, "Ley de Sociedades de Capital" obliges auditors to make observations in their audit of both the annual and director's report with regards to any fact that might pose a threat to the company's financial situation. A similar provision is also found in the Technical Auditing Standards issued by ICAC in 1991 which addresses issues like the independence and conduct of the auditor in carrying out his or her duty among other things.³²⁰ Article 1.5 of that law also requires auditors to pay attention to those situations and circumstances that might jeopardize the company's ability to continue in business. According to RUIZ-BARBADILLO et al., although these rules require auditors to warn users of accounting information if they see risk of bankruptcy in their clients, none of them have provided detailed "procedures for performing the task of going concern evaluation."³²¹

To respond to the expectation gap question and as well fill the necessary regulatory lacuna, Spanish regulators and the professional associations came up with a new auditing standard. The new standard called 'Norma Técnica de Auditoría sobre el Principio de Empresa en Funcionamiento' was published on 31 May 1993 by the ICAC (NTA-May/1993, auditing standard on the going concern assumption).³²² This change was to assist auditors in detecting and conveying the right signal or, if you like, the

³¹⁷ RUIZ-BARBADILLO, E., ET AL., *Audit Quality...*, op. cit., p. 489

³¹⁸ Id. at p. 490.

³¹⁹ Id.

³²⁰ Id.

³²¹ Id.

³²² BOICAC, (1993) 'Resolución de 31 de mayo de 1993, del Instituto de Contabilidad y Auditoría de Cuentas, por la que se publica la Norma Técnica de Auditoría sobre la aplicación del principio de empresa en funcionamiento', *Boletín Oficial del Instituto de Contabilidad y Auditoría de Cuentas*, No. 13, ICAC, Madrid.

“red-flag” to financial statement users if they doubt their client’s ability to continue in business. In addition, the new standard is meant to fill the expectation gap vacuum by providing auditors with guidance on the application of the going concern assumption.

The auditing standard, *inter alia*, specified the scope of auditor’s responsibility in assessing a company’s risk of continuing as a going concern, as well as provided operational guidance to the auditor to enable him or her form an opinion on the question. With the implementation of the new audit standard by the ICAC, the auditor did not only have his or her responsibility defined but had also been provided with a process for evaluating a client’s ability to continue as a going concern.³²³ Moreover, given the atmosphere of sustained criticism and suspicion that informed the reforms in the first place, RUIZ-BARBADILLO *et al.* argue that, all things being equal, the change was expected to motivate auditors to be more vigilant in finding and reporting going concern uncertainties to the public.³²⁴

7.3.2 AUDIT QUALITY AND GOING CONCERN OPINION

Whether the auditing standards promulgated in Spain have achieved their aim of reducing the audit expectation gap is an empirical question that may only be measured by statistics. But for reasons outlined above, empirical literature on going concern opinion in Spain are few and far between. Nevertheless, this thesis will review two important empirical studies conducted on going concern opinion in Spain.

In the first study, published in 2004, RUIZ-BARBADILLO *et al.* attempted to establish a relationship between audit quality and the likelihood of financially troubled companies receiving a going concern opinion. The study covered the period from December 1991 to December 2000. The second study published recently in 2012, examined the impact of the May 1993 auditing standards promulgated in Spain on auditors’ behavior. The study covered the period between 1991 and 1996. Both studies are reviewed below.

³²³ RUIZ-BARBADILLO, E., *ET AL.*, *Audit Quality...*, *op. cit.*, p. 490.

³²⁴ *Id.* at p. 492.

7.3.3 STUDY OF GOING CONCERN OPINION IN SPAIN

This study aims to find out the reasons behind auditors' going concern opinion. Is it to do with competence or independence, or both of them? RUIZ-BARBADILLO et al. took a sample of companies on the brink of bankruptcy. Using this data, they separated problem companies with a going concern opinion from problem companies without a going-concern opinion.³²⁵ They came to the conclusion that although auditors may find a company in financial distress and also doubt its ability to continue as a going concern, yet they may refrain from issuing a going concern opinion because of lack of economic incentive to do so.³²⁶

The results show that the likelihood of auditors issuing a going-concern opinion do not only depend on the company's financial problems, but also on auditor's ability give such an opinion, i.e. the auditor's independence from the company. In other words, the going concern opinion may depend on the auditor's capacity to withstand the risk of losing the client. However, they have not found any evidence linking a going concern opinion with auditor's competence.³²⁷

The firms included in this study have been selected from the database of the National Securities Market Commission for the fiscal year ranging from December 1991 to December 2000 period. This database was chosen because of the access it affords the researchers to the audited financial information of all companies listed on the Madrid Stock Exchange. In addition to being the exclusive place to find annual accounts together with their complete audit reports.³²⁸

At the beginning, the researchers gathered a sample of all the 4,817 audited companies for the years from 1991–2000. They thereafter removed insurance and financial service companies because as they noted “their financial ratios may differ significantly from the rest of the companies and could generate misleading results.”³²⁹ They also eliminated companies in liquidation from the sample because these companies' financial

³²⁵ RUIZ-BARBADILO, E., ET AL., *Audit Quality...*, op. cit., p. 599.

³²⁶ Id. at p. 600.

³²⁷ Id.

³²⁸ Id. at p. 605.

³²⁹ Id.

information is of little significance for users of financial statements. Following this method, the researchers were left with final sample of 3, 119 companies for the study.³³⁰

Next, RUIZ-BARBADILLO et al. determined from this sample those companies that have shown signs of financial distress. They used the trio features of (a) negative working capital; (b) negative retained earnings, or (c) a bottom-line loss as a measure to determine financially distressed companies. Any company that exhibit one or more of these feature is so classified. These variables were selected, as noted by RUIZ-BARBADILLO et al. because they “are also based on the so-called contrary factors identified in the Spanish guidelines (ICAC, 1991).”³³¹ They have also considered those factors that when present can mitigate the problems of financial distress. Mitigating factors are known to serve as justification for auditors to refrain from qualifying an audit report even though the company has going-concern problems. In evaluating the existence of these mitigating factors, RUIZ-BARBADILLO et al. examined the financial statements of subsequent fiscal year to see if there have been some important sales of assets or the issuance of new debt or equity on the part of the companies. Since these are factors that may influence the auditor’s decision, they chose to exclude companies with one or both factors from the sample. They were then left with a sample of 1,199 companies facing impending financial distress for analysis.³³²

In their analysis, RUIZ-BARBADILLO et al. used indicators like probability of failure, tenure, specialization, client size, auditor size, receivable and inventory as yardstick to measure competence and/or independence, the factors that finally determines a going concern opinion.³³³ Each of these variables is taken below.

The authors started with PROBABILITY OF FAILURE (hereafter PROBFAIL), a variable which relates to the financial health of a company. As indicated in a prior research, a company’s financial situation at times may be in so severe or distressed that it would make a going-concern opinion inevitable for auditors.³³⁴ Therefore, RUIZ-

³³⁰ Id.

³³¹ Id.

³³² Id.

³³³ Id. at p. 606.

³³⁴ Id. Accordingly, there are other evidence to the effect that “auditors are more likely to issue going concern opinions for clients reporting larger total accruals. This finding is consistent with auditor conservatism because there is more management judgment, and hence a greater chance of financial

BARBADILLO et al. concluded that when a company has a high probability of failure, chances are that it cannot avoid a going-concern opinion.³³⁵

TENURE is used here to signify the duration of the relationship between auditor and client. As noted by RUIZ-BARBADILLO et al. with time “an auditor develops an in-depth knowledge of the client’s business operations, processes and systems, which is crucial to performing effective audit work.”³³⁶ Some researchers noted that auditors that have a long-term relationship with their clients, have a better understanding of the client’s financial condition which puts them in a better position to detect their client’s going-concern problems. They also argue that there is evidence in the literature to the contrary that long term relationship jeopardizes auditors’ professional diligence and compromises their independence. Therefore, tenure is classified here as a negative influence on the auditor’s behavior.³³⁷

SPECIALIZATION, on the other hand, is a measure of the audit firm’s knowledge base and experience in the industry. A firm’s specialization in an industry is viewed by researchers as a way of improving auditor performance. A research conducted by CRASWELL et al. has shown that audit quality can increase firm’s clientele and its market share.³³⁸ Accordingly, RUIZ-BARBADILLO et al. noted that SPECIALIZATION by auditors leads to “easier identification of financial distress and, therefore, with a higher probability of issuing a going-concern opinion.”³³⁹

CLIENTSIZE is used here to measure the effect of client loss of a given audit firm as a consequence of a qualified opinion issued. Evidence abound that well established auditors may issue a qualified opinion to a client in a dire situation without fear of losing the client. However, RUIZ-BARBADILLO et al. adverted that there is also evidence

statement error, in the presence of larger accruals.” See DEFOND, M., et al., *Do Non-Audit Services...*, op. cit., p. 1254.

³³⁵ Id.

³³⁶ Id. For more detailed discussion on the need by auditors to understand “the client’s business operations, processes and systems, which is crucial to performing effective audit”, please see the works of ELITZUR, R. R. & FALK, H. (1996); O’LEARY, C. (1996); GEIGER, M. A. & RAGHUNANDAN, K. (2002).

³³⁷ Id. The work of CATANACH, A. H. & WALKER, P. L. (1999) is very instructive on the relationship between audit tenure and professional independence.

³³⁸ Id. at p. 607. See also CRASWELL A., ET AL. (1995).

³³⁹ Id.

suggesting that auditors may have economic incentives to issue unqualified opinion to larger companies for fear of losing them.³⁴⁰

AUDITORSIZE is classified here as positive influence on audit firm capable of swinging the pendulum to the side of truth. As RUIZ-BARBADILLO et al. observed, auditors of renowned goodwill are more likely to issue a going concern opinion to deserving client knowing full well that any contrary opinion may affect their reputation as well as value of their services.³⁴¹ In order to protect their reputation auditors will have to maintain a balance between two potentials, a client's probability of receiving a going-concern opinion or harm their reputation.³⁴²

RECEIVABLE and INVENTORY are included here to reflect the potential losses auditors may incur from litigation. Litigation risk may sometimes be a determining factor for auditors when evaluating a going concern opinion. Conservative reporting can at times be the saving grace for auditors because, as noted by RUIZ-BARBADILLO et al. 'qualified audit reports issued prior to bankruptcy reduce both the incidence and the magnitude of litigation if bankruptcy subsequently occurs.'³⁴³ Hence, they classified valued litigation risk positively in determining companies in financial distress.³⁴⁴

7.3.4 THE RESEARCH RESULTS

The research results which mirror the empirical evidence drawn from the United States show that out of the 1,199 cases observed auditors expressed a going-concern opinion in only 100.³⁴⁵ This indicates that auditors are generally reluctant to issue going-concern opinion. In addition, it can be argued that notwithstanding the contextual differences

³⁴⁰ Id.

³⁴¹ Id. KRISHNAN & KRISHNAN sustain that renown audit firm stand to lose more in terms of reputation as well as clientele when it is found misrepresenting the account statements of its clients, a fact that discourages such a behavior. See KRISHNAN, J. & KRISHNAN, J., "The Role of Economic Trade-Offs in the Audit Opinion Decision: An Empirical Analysis, *Journal of Accounting, Auditing and Finance*, 4, 1996 p. 572.

³⁴² Id.

³⁴³ Id. In a study to find out if modified reports prior to client bankruptcy minimizes auditors' liability, CARCELLO & PALMROSE concluded that "[r]esolution evidence for auditor litigation revealed that observations with only modified reports had the highest dismissal rate and the lowest (mean and median) payments; observations with no modified reports had the highest auditor payments. While small sample sizes make these results very preliminary, this resolution evidence suggests that observations with only modified reports have weaker claims. If so, one inference is that modified reports serve to weaken plaintiffs' claims against auditors." See CARCELLO, J. & PALMROSE, Z., "Auditor Litigation and Modified Reporting on Bankrupt Clients, *Journal of Accounting Research*, 32, 1994, p. 27.

³⁴⁴ Id.

³⁴⁵ Id. at p. 608.

that exist between the United States and Spain, the general tendency of auditors issuing less going-concern opinion is true in both countries. Table 1 below is adopted from RUIZ-BARBADILLO et al. and describes the sample of the 1,199 distressed companies observed.

Table 1. Descriptive statistics on the model's variables

Variable	Minimum	Maximum	Mean	Standard deviation
PROBFAIL	0.00	1.00	0.20	0.31
TENURE	1	11	4.59	2.67
SPECIALIZATION	0.00	0.96	0.19	0.24
CLIENTSIZE	0.02	1	0.23	0.35
AUDITORSIZE	0.00	0.73	0.20	0.27
RECEIVABLE	0	0.82	0.16	0.18
INVENTORY	0	0.98	0.08	0.15

PROBFAIL: Probability of company's failure; TENURE: Number of years being audited by the same audit firm; SPECIALIZATION: Audit firm's market share in the client's industry; CLIENTSIZE: Client's assets to total clients' assets of the auditor; AUDITORSIZE: Audit firm's market share; RECEIVABLE: Receivable/total assets; INVENTORY: Inventory/total assets.

Table 2 below is used by RUIZ-BARBADILLO et al. to test the explanatory variables. The test is meant to find if there are any significant differences between companies in financial problems and companies that are not in problem, while the z-statistic in the table is used to compare the means of the two groups. It can therefore be seen in Table 2 that there are significant differences between companies that have financial difficulties that have received a going-concern opinion and those that did not. This situation is invariably reflected in the PROBFAIL variable, where signs of financial failure are greater in the companies that received qualified reports, which is consistent with earlier research results in the field.³⁴⁶

Table 2. Univariate analysis of the explanatory variables classified according to the existence of going-concern or not

Variables	Mean		Median		Standard deviation		z-statistics
	No GC	GC	No GC	GC	No GC	GC	
PROBFAIL	0.174	0.557	0.031	0.648	0.281	0.381	8.967***
TENURE	4.61	4.32	4.00	4.00	2.695	2.287	0.501
SPECIALIZATION	0.193	0.131	0.088	0.080	0.246	0.240	0.359
CLIENTSIZE	0.232	0.189	0.025	0.019	0.353	0.354	2.703***

³⁴⁶ Id. at p. 611.

AUDITORSIZE	0.197	0.211	0.048	0.072	0.274	0.271	3.042***
RECEIVABLE	0.156	0.208	0.089	0.171	0.178	0.169	3.877***
INVENTORY	0.081	0.130	0.005	0.053	0.143	0.203	3.900***

*** denote the levels of confidence ranging from 99%, 95% and 90% respectively.

PROBFAIL: Probability of company's failure; TENURE: Number of years being audited by the same audit firm; SPECIALIZATION: Audit firm's market share in the client's industry; CLIENTSIZE: Client's assets to total clients' assets of the auditor; AUDITORSIZE: Audit firm's market share; RECEIVABLE: Receivable/total assets; INVENTORY: Inventory/total assets.

The TENURE variable, on the other hand, shows no significant differences between companies that received a going-concern opinion and those that did not, which is contrary to what is expected. The common logic backed by some research findings, is that auditors' knowledge and familiarity with their client may significantly sway the balance of audit opinion in favor of the client. Nevertheless, the old argument still holds because the results indicated, albeit slightly, a bias in favor of clients with longer tenure with the auditor. As shown by the results, 'the average length of audit contracts of those companies receiving going-concern opinions is 4.32 years, while among those companies not receiving this qualification it is 4.61 years.'³⁴⁷ Therefore RUIZ-BARBADILLO et al. concluded by lending credence to the thesis that longer audits contracts are not a good remedy for protecting auditors' independence.³⁴⁸

A similar result is found with the SPECIALIZATION variable, which shows a value of only 0.131 in companies that have received qualified reports. This result, according to RUIZ-BARBADILLO et al. is indicative of the fact "that the lower the auditor's degree of knowledge in specific sectors, the greater the company's probability of receiving going-concern opinions."³⁴⁹ However, one variable that has been consistent here is that of economic trade-offs. This variable showed a clear difference between both of the groups, which is also the expected result.

Meanwhile, the CLIENTSIZE variable is meant to measure the estimated cost of loss of a client in case of a qualified opinion. Accordingly, it is a considered opinion of RUIZ-BARBADILLO et al. that clients with a relatively lower weight in auditor's portfolio are more likely to receive qualified audit report than clients with higher weight in the auditor's portfolio even if both companies seem to be in distress. With respect to

³⁴⁷ Id. at p. 610.

³⁴⁸ Id.

³⁴⁹ Id.

AUDITORSIZE variable, the results of the research shows that audit firms with good reputation protect their reputation jealously and therefore will issue a going-concern opinion in deserving cases. Finally, the RECEIVABLE and INVENTORY variables used here to deduce litigation risk, show a higher value in companies that have received going-concern opinions than companies that did not.³⁵⁰

RUIZ-BARBADILLO et al used table 3 below to show the results from the analysis of the “model used to estimate the relationship between audit quality and the auditor’s going-concern reporting decision. Three goodness-of-fit measures (the likelihood ratio test, the pseudo-R² and the percentages of concordant pairs) are shown. The x² model is highly significant, suggesting that the variables in the models did indeed have joint significance. The logit pseudo-R² indicates how well the data fit the presumed underlying theoretical distribution. Pseudo-R² is computed as an x² model divided by the number of observations minus the number of variables plus one plus the x² model. The value of pseudo-R² is 0.227.” The authors also “detail the percentage predicted correctly by both models (79.4% predicted correctly).”³⁵¹

As can be seen, there is a consistency between this result and that of the univariate analysis in Table 2. As expected, the PROBFAIL variable demonstrates a coefficient that is statistically different from zero. This goes to show that when a company’s financial distress level is so high, there is a high probability of that company receiving a qualified audit report. In such situation auditors can only do the inevitable by issuing going concern opinion if they are to avoid trouble themselves.³⁵²

Table 3. Logistic regression results

Variables	Expected sign	Coefficient (Wald)
Constant	?	-10.0*** (91.453) 2.644*** (75.64)
PROBFAIL	+	
TENURE	+	0.011 (0.060)
SPECIALIZATION	+	-2.061 (0.032)
CLIENTSIZE	-	-12.0*** (12.128)
AUDITORSIZE	+	2.593*** (15.11)

³⁵⁰ Id. at p. 611.

³⁵¹ Id.

³⁵² Id.

RECEIVABLE	+	0.013(0.001)
INVENTORY	+	0.321(0.114)
Pseudo-R ²		0.229
X ² Statistics (with 7 degree of freedom)		117.61
% Correctly classified		79.7

PROBFAIL: Probability of company's failure; TENURE: Number of years being audited by the same audit firm; SPECIALIZATION: Audit firm's market share in the client's industry; CLIENTSIZE: Client's assets to total clients' assets of the auditor; AUDITORSIZE: Audit firm's market share; RECEIVABLE: Receivable/total assets; INVENTORY: Inventory/total assets.

The TENURE and SPECIALIZATION variables also performed as expected, but their coefficients are statistically insignificant. Another consistent variable is that of the CLIENTSIZE with coefficient different from zero as expected.

The finding of RUIZ-BARBADILLO et al. goes to confirm the thesis that companies with less weight in the auditor's portfolio are more probable to receive a going concern opinion when in financial problems. This result supports other research findings that intervening factors like pressure from a reputable client may force the hands of the auditor especially in Spain where companies can hire and fire auditors at will. Thus, at times going concern decisions are hard calls for auditors given the competitive nature of the Spanish audit market and the probability they face of losing their client. In situations like this auditors lack the incentive to reveal the financial difficulties of their client if they risk losing such an important client.³⁵³

In direct contrast to what client size may signify in terms of influence on their auditors, the AUDITORSIZE is a counter force to such influence. As can be seen in the table, the coefficient of AUDITORSIZE variable is significantly different from zero, which indicates that big audit firms with renowned goodwill have incentives to reveal their clients financial problems. These kinds of audit firms place more prominence to their reputation in audit reporting. Any damage to their reputation in terms of important error of judgment could cause them clientele as well as market share.³⁵⁴

³⁵³ Id. at p. 613.

³⁵⁴ Id.

Finally, as reflected in the table, the variables representing RECEIVABLES and INVENTORY are statistically insignificant, which suggests that litigation risk does not deter or determine auditor behavior in Spain. This is largely due to the low litigation risk in the Spanish audit environment which is changing very fast.

7.4 THE IMPACT OF AUDITING STANDARDS ON EXPECTATION GAP

In their recently published study on audit expectation gap, RUIZ-BARBADILLO et al. examined the impact of auditing standards in relation to auditors' behavior when assessing a going concern opinion. They particularly centered on the NTA-May/1993 auditing standards to determine whether its implementation has been accompanied by the desired change of attitude on the part of auditors.³⁵⁵

Auditing rules are known to be implemented as a response to public criticism in the aftermath of crisis and have as a main goal is setting a benchmark for a minimum acceptable quality and professional competence in the auditing practice. As such, when a new standard bar is implemented in the form of auditing standards, a correspondent change of behavior should as well be expected of auditors. In fact, RUIZ-BARBADILLO et al. assume in this study that the adoption of the NTA-May/1993 standards in Spain would increase the number of modified audit report.³⁵⁶

In this study, RUIZ-BARBADILLO et al. focused on companies quoted on the Spanish stock market from 1991 to 1996 financial years, albeit, excluding financial companies. They gathered the data from the sample of 2,070 companies quoted on Spanish stock exchange. From this number, they used the indicators of 'negative working capital; a loss from operations in two consecutive financial years; and stockholders' equity being lower than the capital figure' to select their sample.³⁵⁷

After applying the above criteria they were left with a final sample of 412 companies for observation. Out this number about 123 companies representing 30% relates to 'the period before the issuance of the audit standard (1991–1992), while 289 (70%) refer to

³⁵⁵ RUIZ-BARBADILLO, E., ET AL., Auditing Standards..., op. cit., p. 485.

³⁵⁶ Id. at p. 491.

³⁵⁷ Id. at p. 493.

the subsequent period (1993–1996).³⁵⁸ They identified only 16% of qualified going concern reports, i.e. 65 companies. Out of this number 23 qualified audit reports were issued in the period prior to the issuance of NTA-May/1993 auditing standards, which stands at 18.7%. The remaining 42 qualified audit reports were issued after the implementation of NTA-May/1993 standards, which represents 14.5%. RUIZ-BARBADILLO et al. therefore, asserted that the ‘ICAC resolution NTA-May/1993 concerning the going concern principle has not impacted upon the auditors’ decision on whether to issue a modified going concern audit report.’³⁵⁹

The authors went on to analyze qualified going concern audit reports of individual audit firms in similar periods i.e. before and after NTA-May/1993 standards.³⁶⁰ In view of the fact that auditors are obliged to comply with auditing rules made to streamline the criteria for identifying companies with financial problems and risk of continuing in business, some level of consistency should be expected in reports issued by different audit firms. However, this is not the case because of some evidence in the audit literature suggesting that auditors do not alter their behavior subsequent to new auditing standards. So this study is undertaken to determine whether there is any change of propensity to issue a qualified opinion subsequent to the implementation of NTA-May/1993.³⁶¹

Although the results show no change in auditors’ tendency to issue qualifying audit reports, there is a notable difference among the individual firms. For instance, the results reveal that the qualified reports issued by AA in the period 1991 to 1992 amounted to 18% of its financially distressed clients i.e. before NTA-May/1993 standards. After the implementation of the new standards in 1993-1996 this percentage dropped to 8%. The same results are found in cases of CL, which saw a significant decrease in the percentage of qualified audit reports issued to its clients in the period under investigation. Other firms like DT, KPMG and OTH witnessed an increase in the percentage of qualified audit reports issued to distressed clients. EY on the other hand

³⁵⁸ Id.

³⁵⁹ Id. at p. 497.

³⁶⁰ The audit firms examined in this category are the following: Arthur Andersen (AA); Coopers & Lybrand (CL); Deloitte & Touche (DT); Ernst & Young (EY); KPMG Peat Marwick (KPMG); Price Waterhouse (PW); other auditors (OTH).

³⁶¹ RUIZ-BARBADILLO, E., ET AL., *Auditing Standards...*, op. cit., p. 497.

saw a slight decrease in its reports. The authors did not find any significant link between the reports of the remaining firms and the new auditing standards.³⁶²

The findings of these studies have been mixed for many reasons. First, auditing standards prescribe guidelines on determining going concern in a general, and at times, ambiguous language which is amenable to different interpretation. Secondly, in following these guidelines auditors apply their individual judgments that may vary in accordance with their experience and knowledge of the industry as well as the company in question. The third reason, according to RUIZ-BARBADILLO et al., has to do with cost of applying the new rules. Adapting auditing procedures to the new standards entails additional costs to auditors that include among others staff training. This, of course, affects audit firms in different measures, ‘depending on their size and their client portfolio.’³⁶³ If the additional cost is to be transferred to clients, then its impact on smaller firms will be greater than bigger firms and thereby leave the smaller firms at a competitive disadvantage. That being the case, these audit firms will be reluctant in applying the new standards which inevitably affects their audit quality.³⁶⁴

8. REDUCING THE EXPECTATION GAP

The constant rise in litigation against auditing firms has been cited as evidence of the widening in the expectation gap and a reflection of a change in public opinion concerning the role of auditors.³⁶⁵ Although, it is argued that the nature of the components of the expectations gap make it difficult to eliminate. It is possible that it can be reduced substantially. For this reason a number of researchers and professional bodies have examined and provided valuable insight into how this may be achieved. These approaches are discussed below.

8.1 EXPANDED AUDIT REPORT

The expanded audit report is a method employed to improve the communication gap, making changes to the wording of the audit report particularly arcane phraseology appearing in audit reports, giving meaningful information on the business enterprise and

³⁶² Id. at p. 498.

³⁶³ Id.

³⁶⁴ Id.

³⁶⁵ AICPA, Major Issues for the CPA Profession and the AICPA, New York, 1984.

also sharing the auditor's findings. This change is based on the premise that if users better understood the code being used by auditors in reporting their opinions, they would more accurately perceive the messages being given by the various forms of audit report.³⁶⁶ Indeed, there have been signs of improvement.

A study conducted in the United States by NAIR & RITTENBERG found that following the introduction of the expanded audit reports, perceptions of users about the relative responsibilities of management and auditors is changing.³⁶⁷ KELLY & MOHRWEIS sustain that with the modification of words used in audit reports, users now appreciate the nature of audit more.³⁶⁸ Another study by MILLER et al. also revealed that 'bankers found expanded audit reports to be more useful and understandable than the short form reports.'³⁶⁹ Generally, it can be found from these studies that the 'expanded audit report gives a fuller understanding of the scope, nature and significance of the audit and influences the reader's perceptions concerning the audit and the auditor's role.' That is, an expanded audit report is in one way or another helping to reduce the audit expectation gap.³⁷⁰

8.2 EDUCATING THE PUBLIC

Public awareness and education on the role and function of audit has been suggested as a means of reducing the expectations gap. Some studies have found evidence to support the thesis that knowledge of users of audit has direct influence on how they perceive the expectation gap. Hence, some researchers advocate education in narrowing the expectation gap. For instance, in a study conducted by BAILEY et al. in the US, it came to light that more knowledgeable users placed less responsibility on auditors than less knowledgeable users, which implies a larger gap among less sophisticated users than are more informed users.³⁷¹ Similarly, EPSTEIN & GEIGER found that investors with broader

³⁶⁶ KOH, H. C. & WOO, E., "The expectation gap in auditing", *Managerial Auditing Journal*, 13, 1998, p. 150.

³⁶⁷ NAIR, R. & RITTENBERG, L., "Messages Perceived from Audit, Review, and Compilation Reports: Extension to more Diverse Groups", *Auditing, a Journal of Practice and Theory*, 7, 1987, pp. 15-38.

³⁶⁸ KELLY, A. & MOHRWEIS, L., "Banker's and Investors' Perceptions of the Auditor's Role in Financial Statement Reporting: the Impact of SAS No. 58", *Auditing: A Journal of Practice and Theory*, 9, 1989, pp. 87-97.

³⁶⁹ MILLER, J., REED, S. & STRAWSER, R., "The New Auditor's Report: Will it close the Expectations Gap in Communications?" *The CPA Journal*, 60, 1990, pp. 68-72.

³⁷⁰ KOH, H. C. & WOO, E., *The Expectation...*, op. cit., p. 150.

³⁷¹ BAILEY, K.E., BYLINSKI, J.H. & SHIELDS, M.D., "Effects of Audit Report Wording Changes on the Perceived Message", *Journal of Accounting Research*, 21, 1983, pp. 355-70.

understanding of accounting and finance are less likely to demand higher auditor assurance. They therefore proposed increased public awareness of the nature and limitations of audit as another means of narrowing the expectation gap.³⁷²

A similar conclusion was reached by the Treadway Commission.³⁷³ The Treadway Commission conducted a study in October 1985 of the financial reporting system in the United States to find more effective ways to prevent fraudulent financial reporting. In its final report, issued in October 1987, the Commission recommended for the need to improving the communication between auditors and the public regarding the auditor's role, the Treadway Commission concluded that:

Auditors can and should do a better job of communicating their role and responsibilities to those who rely on their work. Users of audited financial statements need to understand better the nature and the scope of an audit and the limitation of the audit process.³⁷⁴

The Commission also suggested that there is no better way to increase users' knowledge and awareness than to communicate the auditor's responsibility more clearly and explicitly to report readers, which include limitations of an audit at every available chance, like in shareholder meetings. Another way is to have the audit report explicitly indicating reasonable assurance.³⁷⁵ But EPSTEIN & GEIGER argued that both auditors and users of audit reports must re-examine the fundamental role of an audit in society and find a way to close the gap, and there is no better way to close the expectation gap than through education.³⁷⁶

8.3 STRUCTURED AUDIT METHODOLOGIES

With continued rise in litigation against auditors, more audit firms increasingly resort to the use of auditor decision aids in order to narrow the expectation gap, and eventually reduce their liability exposure. Decision aids or audit support systems are technology

³⁷² EPSTEIN, M.J. & GEIGER, M.A., "Investor Views of Audit Assurance: Recent Evidence of the Expectation Gap", *Journal of Accountancy*, 177, 1994, pp. 60-6.

³⁷³ National Commission on Fraudulent Financial Reporting, Report of the National Commission on Fraudulent Financial Reporting, October 1987.

³⁷⁴ *Id.* at p. 57.

³⁷⁵ *Id.*

³⁷⁶ KOH, H. C. & WOO, E., *The Expectation...*, op. cit., p. 150.

applications used by audit firms to enhance audit effectiveness and efficiency. The systems they usually employ include electronic work-papers, extensive help files, accounting and auditing standards, relevant legislation, etc. Audit firms believe that decision aids can enhance audit quality through promoting compliance with accounting standards and the firm's methodology. With increased and consistent audit efficiency, auditors believe they can deliver high-quality audits and thereby keep audit liability at bay. JENNINGS et al.³⁷⁷ took an empirical study to measure the 'legal impact of the increased use of audit decision aids and structured audit approaches in the audit environment.' Their results 'revealed that decision aids are used as surrogate standards of the auditors by jurists. That is, jurists do accept and use audit decision aids as a method to increase or at least maintain auditing standards.'³⁷⁸

8.4 EXPANDING AUDITOR'S RESPONSIBILITIES

HUMPHREY et al., on other hand, suggested a more radical ways to combat the expectation gap. They are of the view that the public would not abandon the belief they have that auditing involves fraud detection through the approaches suggested above like educating the public, or modifying the length of the audit report, or trying to pretend that audit failures are exceptions blown out of proportions by the media. In the alternative, they came up with three solutions: 'setting up an independent office for auditing to enhance auditor independence by overseeing the appointment of auditors of large companies and to regulate audit fees; extending auditors' responsibilities by statute so that they clearly include responsibilities to shareholders, creditors and potential shareholders; and clarifying that auditors have a duty to detect fraud.' However noble this proposal may sound, KOH & WOO were quick to advert that given 'the magnitude of the expectation gap and the costs and benefits of these suggested solutions need to be carefully assessed before any solution is implemented.'³⁷⁹

O'MALLEY³⁸⁰ is in agreement with HUMPHREY et al. that detection of fraud should be made part of auditors' responsibility. He proceeded to propose the following four

³⁷⁷ JENNINGS, M., RECKERS, M.J. & KNEER, D.C., "The Significance of Audit Decision Aids and Precase Jurists' Attitudes on Perceptions of Audit Firm Culpability and Liability", *Contemporary Accounting Research*, 9, 1993, pp. 489-507.

³⁷⁸ KOH, H. C. & WOO, E., *The Expectation...*, op. cit., p 151.

³⁷⁹ Id.

³⁸⁰ O'MALLEY, S. F., "Legal Liability is having a Chilling Effect on the Auditor's Role", *Accounting Horizons*, 7, 1993, pp. 82-7.

additional responsibilities worth considering by the auditing professional bodies like: ‘management and auditor evaluation of internal control systems; compliance reporting; direct reporting by auditors to regulators; and auditor association with interim financial information.’ O’MALLEY, nonetheless, adverted to the risk that the application of his proposal might pose to auditor liability and advised that the liability crisis must be addressed first. Arguably, an ‘expansion of auditors’ responsibilities will not be feasible as long as the liability system operates as a risk transfer mechanism, with auditors as the prime transferees.’³⁸¹

9. AUDI ALTERAM PARTEM-SPAIN

The mercantile reforms implemented by Spain in the 1980’s drew much from a better experimented audit environment like that of the United States especially, as the chunk of the audit practice in Spain as well is undertaken by the same players on both sides of the Atlantic. The 1988 Audit Law, apart from some regulation it ceded to the audit professional organizations, it created a quasi-official regulatory body known as ICAC. The body was assigned with monitoring and investigating the activities of the audit profession, an experiment which has worked relatively well. A glowing testimony to the ‘dominant belief that the audit function can deliver what is expected of it ‘if only’ the appropriate (regulatory) system can be established.’ Also a great stride without a doubt that ‘reinforced the need to broaden the focus of debates on audit expectations; to move from a situation which (at best) implicitly assumes the general applicability of the British/American context to one which actively seeks to explore differing local contexts and reactions to existing and changing audit systems’. Drawing from the relative success of the ICAC, GARCÍA BENAÚ & HUMPHREY argued that:

The particular significance of broadening analysis from the privileged confines of Anglo-Saxon contexts is well illustrated by reference to the present nature of audit regulation in Spain. In the Instituto de Contabilidad y Auditoria de Cuentas (ICAC), Spain would appear to have the type of regulatory body monitoring and investigating the activities of the audit profession that increasingly is being demanded by a variety of interest groups in Britain....Given our concerns as to

³⁸¹ KOH, H. C. & WOO, E., *The Expectation...*, op. cit., p. 151.

the tendency of regulatory proposals to presume an audit potential, we would stress the importance of such investigative powers in opening up the audit function to greater public scrutiny and in assessing the appropriateness of its role in the pursuit of corporate and social accountability.³⁸²

The Spanish regulatory structure was attended with criticism stemming from the view that the Spanish structure should have imitated those countries with longstanding auditing traditions like the United States or the United Kingdom where self-regulation by independent professional associations has always been emphasized. A sentiment well captured by CEA GARCÍA:

Many have criticized this [current regulatory] model as unduly interventionist, and although this adjective may be more or less accurate, it must be said that above all it is the logical consequence of the previous situation of confrontation existing in Spain for many years between the various professional groups, each of which considered itself to have legitimate rights to take responsibility for the practice of auditing. . . . The ideal solution would be for the various bodies to be merged into a single powerful entity that would group together all Spanish auditors, because if this occurred the effective intervention by the Administration (eg. ICAC) would be very substantially reduced, and the auditing profession would largely be run by that single professional organization.³⁸³

Well, time changes and “alternative perspectives on the accounting function are generally being communicated, particularly in countries where English is not the first spoken language”, and have been vindicated with hindsight. This is perhaps the case with the Sarbanes-Oxley Act provoked by the Enron and Arthur Andersen failures in the late 2001 and early 2002, respectively. The act greatly altered the regulatory regime of auditing by shifting the oversight of audit firms from the private-sector American Institute of Certified Public Accountants to the quasi-governmental Public Company Accounting Oversight Board, a body prototype of the Spanish ICAC.

³⁸² GARCÍA BÉNAU, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., at p. 317.

³⁸³ Id. at p. 317 (quoting CEA GARCÍA, J. L., 1992)

CHAPTER III

PART 1

AUDITOR LIABILITY AS PURE ECONOMIC LOSS

1. INTRODUCTION

As seen in the above chapters, audit of financial statements is obligatory in the United States as well as in Spain. Despite the differences between the two legal environments, auditor's relationship with the audited company is generally based on contract in both jurisdictions.³⁸⁴ The company's management after preparing the financial statements employs the auditor to conduct an audit and determine if the assertions made in the financial statements fairly portray the operation of the company's business. Before embarking on the audit, the auditor usually prepares an "engagement letter" in which the scope, duties and responsibilities of both parties are clearly specified.³⁸⁵ Accordingly, the first point of call to determine the auditor's liability is the engagement letter.³⁸⁶ In fact auditors have increasingly included clauses in the engagement letter to limit their liability to the client.

After reviewing the client's records and the evidence that supports those statements, the auditor issues a report. The report expresses the auditor's independent and professional opinion on whether the statements fairly represent the financial status of the entity.³⁸⁷ In the report the auditor certifies that he has examined the accounts in accordance with the GAAS, and has found the financial statements, taken as a whole, to be in conformity with GAAP and fairly presents all material aspects of the financial position, results of operations and changes in financial position of the client.³⁸⁸ In this assessment, the auditor is required to be objective and maintain independence with his client, as required by the AICPA professional ethics code as follows:

³⁸⁴ VICK, S., *Bily v. Arthur Young & Co.*, op. cit., p. 1341.

³⁸⁵ SPELLMIRE, G., ET AL. (1990) in VICK, S., *Bily v. Arthur Young & Co.*, op. cit., p. 1341.

³⁸⁶ The engagement letter in this case is the contract document that sets out the parties' rights and duties. See GARRISON, A. F., "Common Law Malpractice Liability of Accountants to Third Parties", *Wash. & Lee L. Rev.* 44, 1987, p. 188, accessed on January 5 2013 at <http://scholarlycommons.law.wlu.edu/wlulr/vol44/iss1/10>

³⁸⁷ NUNN, L. E., "CPA Liability: A Crisis of Confidence? Is the Auditor a Watchdog or a Bloodhound?" *International Business & Economics Research Journal*, 2, 2001, p. 64.

³⁸⁸ Id.

For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.³⁸⁹

The audit culminates with the delivery of the audit report to the client.³⁹⁰ But the audited financial statements acquire value when the client presents it to the investing public to raise capital.³⁹¹ Arguably, the essence of audit is in the trust the public places on it when making investment decision. However, according to FEINMEN, “auditing is a mix of judgment and technique which may result in certain pitfalls.”³⁹² FEINMAN further argues that “auditors can make seemingly reasonable judgments”, which may be questioned by third parties who later rely on the audit, or they may fail to discover an error or may reach a wrong conclusion on the financial position of their client.³⁹³ The third parties who rely on the audit and suffer loss frequently sue auditors to recover their loss. However, financial loss that is not accompanied by injury or damage to property is classified by common law courts as pure economic loss and therefore not recoverable. How the concept of pure economic loss is shaped over the time by the courts to accommodate third party claims is discussed next.

2. THE CONCEPT OF PURE ECONOMIC LOSS

2.1 INTRODUCTION

Under common law, legal claims brought for compensation for damages caused by negligent acts are tried under the principles of tort of negligence.³⁹⁴ But because liability for negligent misstatement is not an autonomous category within the law of negligence it is usually analyzed in the wider context of economic loss.³⁹⁵ It is trite law that economic loss is formerly not recoverable under common. Does this apply to a civil law

³⁸⁹ ET Section 55.03, AICPA, Code of Professional Conduct and Bylaws, Professional Standards, 2013.

³⁹⁰ NUNN, L. E., CPA Liability..., op. cit., p. 64.

³⁹¹ GARRISON, A. F., Common Law Malpractice..., p. 188.

³⁹² FEINMAN, J. M., Liability of Accountants..., op. cit., p. 22.

³⁹³ Id.

³⁹⁴ Auditors may also be held liable on criminal grounds, under state or federal law.

³⁹⁵ KHOURY, L., Liability of Auditors..., op. cit., p. 427.

jurisdiction like Spain as well? The following paragraphs will try to answer this question by comparing the application of pure economic loss rule under the tort laws of civil and common law systems as respectively represented by Spain and the United States. It will appraise the courts' reluctance to allow recovery not linked with physical loss or injury for the fear that such admission would open the door to mass litigation which might very well overwhelm the courts. It is argued that the mutual concern common law and civil law courts share, of an open-ended liability, led to invocation of policies like the concept of duty in case of common law and causation for civil law to bring liability exposure to a reasonable limit. Attention will also be given to the uncertainty regarding the prerequisites for compensation of economic loss and the lack of consistent framework in determining recoverability. It concludes by contending that the economic loss rule is a necessary mechanism that serves the ends of the law and that of society as well. However, before proceeding to examine the economic loss concept, it is convenient to start with what tort is and how it relates to contract.

2.2 TORT OF NEGLIGENCE AND ECONOMIC LOSS

2.2.1 TORT DEFINED

Tort is originally a French word for wrong but fortunately, not all wrongs are remedied at law.³⁹⁶ God forbid that the law should furnish remedy for all wrongs! A tort is, thus, known in common law as a violation of some private obligation by which like damage accrues to the individual.³⁹⁷ It is a civil wrong, other than a breach of contract, for which the law will provide a remedy in the form of an action for damages.³⁹⁸ Tort law seeks to protect the rights and privileges of persons against wrongful acts by others. This is premised on the policy that a person who unreasonably interferes with the interest of another should be liable for the resulting injury and thus provides redress from wrongful acts that affect some legal interest of the complaining party. While negligence, according to WINFIELD,³⁹⁹ is a violation of a legal duty to take care which results in

³⁹⁶ MULLIS, A. & OLIPHANT, K., *Torts* Palgrave Macmillan, London, 2011, p. 1.

³⁹⁷ BLACK, H. C., *A Law Dictionary* The Law Book Exchange Ltd., New Jersey, 1995, p. 1161. See also OWEN, D. G., "The Five Elements of Negligence", *Hofstra Law Review*, 35, 2007, 1674, where the learned author argues that duty as "obligation of one person to another, flows from millennia of social customs, philosophy, and religion. It serves as the glue of society; it is also the thread that binds humans to one another in community. Duty constrains and channels behavior in a socially responsible way before the fact, and it provides a basis for judging the propriety of behavior thereafter." *Id.*

³⁹⁸ *Id.*

³⁹⁹ WINFIELD, P. H., *The Province of the Law of Tort* (Cambridge University Press, 1931), p. 32.

damage to the claimant. It is the most common area of torts law in modern jurisprudence and perhaps also the broadest category of tort liability imposed for harm caused to others.

The Spanish perspective on tort law, which somehow reflects the common law, is also fault-based (*culpa*), premised on the obligation of the tortfeasor to repair any damage his action or omission caused to the complainant.⁴⁰⁰ The significance of fault under this system is that damage alone is not sufficient to sustain a claim; there must be fault or negligence on the part of the defendant as required by art. 1902 CC. However, with the advent of new technologies, the chances of massive tort have multiplied sometimes with no apparent fault. Spanish courts have therefore, transformed the doctrine of fault “*culpa*” to mirror the damage rather than how it was caused. The courts now would compensate all torts, “*ubi jus ibi remedium*”,⁴⁰¹ without following strict requirement of fault. Once there is link between the complained act and the damage suffered by the complainant, referred to in Spanish law as “*relación causa y efecto*”.⁴⁰²

It was formerly a settled law in common law jurisdictions that liability in tort did not extend to pure economic loss, in the absence of physical damage. Claims for pure economic loss were rejected out rightly by common law courts. The position of the law then was that an aggrieved person who wants to claim compensation for the loss suffered must come under an action for breach of contract or for negligence. Once the plaintiff could not prove privity the action under contract would fail. Any claim under the tort of negligence would as well not succeed unless there was proximity between the plaintiff and the defendant or the damage is reasonably foreseeable to the defendant and must not be remote. Apart from all these, the plaintiff must also show that the loss suffered by him was not pure economic loss, in order to be recoverable.

Common law courts viewed the allocation of risks and opportunities of pure economic loss as exclusive to parties in contract.⁴⁰³ In fact one of the reasons adduced for refusing to impose liability for pure economic loss has been the need to prevent the disruption of

⁴⁰⁰ Article 1902 of the Spanish Civil Code, (Hereinafter CC).

⁴⁰¹ Wherever there is right there is remedy, as the saying goes.

⁴⁰² INFANTE RUIZ, F. , *La Responsabilidad por Daños: Nexo de Causalidad y “Causas Hipotéticas”*, Tirant lo Blanch, Valencia, 2002, p. 1.

⁴⁰³ This had been the state of the law until the case of *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465

the ‘contractual structure’. Hence the general rule under common law is that third parties can neither be bound nor be endowed by an agreement to which they are not a party. Only parties who have furnished a consideration can claim.⁴⁰⁴ Under this rule a disappointed beneficiary of a will, not properly performed cannot have a valid claim against the solicitor.⁴⁰⁵ In America, however, since the second half of the 19th century the courts have progressively abandoned consideration as an excuse for refusing to enforce contracts on behalf of third parties.⁴⁰⁶ “Thus, in the earlier part of the 20th century,” we find the American courts setting the pace in admitting liability in the context of negligent statement.⁴⁰⁷

This position brought American law on par with Spanish law. In Spain the concept of pure economic loss is ipso facto a *non sequitur*.⁴⁰⁸ Spain has a general system of liability which in principle does not limit the sphere of its protection. Accordingly all kinds of damage are compensated, be they physical or economic.⁴⁰⁹ Thus, rights and interest are not classified according to their importance or the level of protection they enjoy under the law. The notion of some damage being “consequential” loss and therefore recoverable and others being “pure” economic loss present in common law is of no consequences under Spanish legal tradition.⁴¹⁰

⁴⁰⁴ This rule known as “privity rule” has been abrogated in the UK by the *Contracts (Rights of Third Parties) Act 1999* to enable third parties enforce contracts made for their benefit.

⁴⁰⁵ *Groom v. Crocker* [1939] 1 KB 194

⁴⁰⁶ COESTER, M. & MARKESINIS, B., “Liability of Financial Experts in German and American Law: An Exercise in Comparative Methodology”, *The American Journal of Comparative Law*, Vol. 51, 2003, p. 293, accessed on May 6 2012 at: <http://www.jstor.org/stable/3649150>. See also *Lawrence v. Fox* 20 N.Y. 268 (N.Y. 1859), where the New York Court of Appeals affirmed that a third party can maintain an action to enforce a contract not entered by him directly. Since this decision the courts in the U.S. have generally accepted third party’s right to enforce a contractual obligation made for his benefit.

⁴⁰⁷ Please see the judgment of Benjamin Cardozo in *Glanzer v. Sheppard* (1922) 233 N.Y. 236, 135 N.E. 275. The English courts and by extension other common law jurisdictions including Nigeria only began admitting liability for negligent misstatement from the case of *Hedley Byrne* supra.

⁴⁰⁸ MARTIN-CASALS, M. & JORDI RIBOT, I., “Compensation for Pure Economic Loss under Spanish Law” in VAN BOOM, W. H., KOZIOL, H. & WITTING, C. A., (eds.), *Pure Economic Loss: Tort and Insurance Law*, Springer Wien (New York), 2003, p. 62.

⁴⁰⁹ *Id.*

⁴¹⁰ This notion has been incorporated into the Principles of European Tort Law (PETL) under its Art. 2:102, (Protected interests), which provides thus: (1) The scope of protection of an interest depends on its nature; the higher its value, the precision of its definition and its obviousness, the more extensive is its protection. European Group on Tort Law 2 (2) Life, bodily or mental integrity, human dignity and liberty enjoy the most extensive protection. (3) Extensive protection is granted to property rights, including those in intangible property. (4) Protection of pure economic interests or contractual relationships may be more limited in scope. In such cases, due regard must be had especially to the proximity between the actor and the endangered person, or to the fact that the actor is aware of the fact that he will cause damage even though his interests are necessarily valued lower than those of the victim. Accordingly, bodily and property damage receive more protection than economic loss.

The Spanish law maintains a broader view of contract that is derived from the notion of freedom of contract itself. It is premised on the fact that if the function of the court is to give life to the skeletal intentions of the parties, there can be no reason why the law should not draw consequences for third parties, not merely from the will of the contracting parties but also from the nature of the contract celebrated. As enshrined under article 1257 CC:

Los contratos sólo producen efecto entre las partes que los otorgan y sus herederos; salvo, en cuanto a éstos, el caso en que los derechos y obligaciones que proceden del contrato no sean transmisibles, o por su naturaleza, o por pacto, o por disposición de la ley.

Si el contrato contuviere alguna estipulación a favor de un tercero, éste podrá exigir su cumplimiento, siempre que hubiese hecho saber su aceptación al obligado antes de que haya sido aquélla revocada.

Thus, by the provision of the above quoted section, depending on the nature and type of the transaction, third parties can enforce a contract made for their benefit. Under Spanish law therefore; there is no question as to the recoverability in tort for negligently performed service. For instance, in addition to their liability in contract auditors and notaries are also liable to third parties in tort under sections 705 and 1902 CC respectively⁴¹¹

2.2.2 DEFINITION OF PURE ECONOMIC LOSS

What then does pure economic loss signifies? ‘After all pure economic losses are eventually measured in economic terms.’⁴¹² There seems to be no consensus on the exact contents of the phenomenon of pure economic loss.⁴¹³ Perhaps for the simple reason that a number of legal systems neither recognized the legal category nor distinguish it as an autonomous form of damage. Where the concept is recognized

⁴¹¹ VAN BOOM, W. H., ET AL. (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 69.

⁴¹² XIAO-WEI, N., *Recovery of Pure Economic Loss in Construction Industry*, Master of Sciences Thesis (Inedited), University of Technology, Malaysia, 2007, p. 27, accessed on January 15 2011 at: <http://eprints.utm.my/5974/>.

⁴¹³ BUSSANI, M. & PALMER, V. V. (eds.), *Pure Economic Loss in Europe*, Springer Wien (New York), 2003, p. 4.

however, it is mostly associated with no liability rule.⁴¹⁴ FELDTHUSEN defined pure economic loss as “a financial loss not causally consequent upon physical injury to the plaintiff or his property or other infringement of his absolute (that is, protected erga omnes) rights.”⁴¹⁵ It generally refers to a negative change in the victim’s financial state that does not affect his person or property.⁴¹⁶

2.2.3 THE DIFFERENCE BETWEEN CONSEQUENTIAL AND PURE LOSS

Economic loss is referred to as “consequential” and therefore compensated when it follows “immediately” or “directly” from the causation of a physical injury to the plaintiff’s own person or property.⁴¹⁷ A clear example is of a claimant who suffers personal injuries, and was allowed to recover his loss of earnings; a ship owner, whose ship is sunk or damaged, recovers for his loss of freight.⁴¹⁸ It is however referred to as “pure” and therefore non-recoverable “when it is not consequent on bodily injury to the claimant or on physical damage to land or chattel in which the plaintiff has a proprietary interest”.⁴¹⁹ The common law precedent on this class of cases dates back to the seminal cases of *Cattle v. Stockton*⁴²⁰ and *Simpson v. Thomson*.⁴²¹ In laying down this principle his Lordship, Lord PENZANCE argued in the case of *Simpson v. Thomson* that:

The principle involved seems to me to be this – that where damage is done by a wrongdoer to a chattel not only the owner of that chattel, but all those who by contract with the owner have bound themselves to obligations which are

⁴¹⁴ SCHWARTZ, G. in BANAKAS, E. (ed.), *Civil Liability for Pure Economic Loss*: Kluwer Law International, 1996, p. 103.

⁴¹⁵ FELDTHUSEN, B., *Economic Negligence: The Recovery of Pure Economic Loss*, 4th Edition, Canada, 2000, p. 4.

⁴¹⁶ Id.

⁴¹⁷ Consequential economic loss is compensable in all common law jurisdictions. See for example *Nat’l Corp. v. Great Lakes Towing Co.*, 574 F.2d 339, 343 (6th Cir. 1978) “When a defendant’s negligence results in an interference with the use of plaintiff’s property, the plaintiff is entitled to recover the value of the use during the interference, or the value of the amount paid for a substitute.” “It is indeed every-day practice in injury cases, where the plaintiff is given loss of earnings or profits during the time his injury lasts as the direct consequences of the injury.” *Elliot Tug Co. v. Shipping Controller*, (1922) 1 K.B. 127, 140

⁴¹⁸ *SCM (United Kingdom) Ltd v. W J Whittall & Son Ltd.* [1971] 1 QB 337

⁴¹⁹ Please see GILEAD, I. in HAUSMANINGER, H., ET AL (eds.) *Developments in Austrian and Israeli Private Law*, Vienna, Springer, 1999, p. 203.

⁴²⁰ [1874-1880] All E.R. 220, in this case, the plaintiff sued in his own name to recover the loss he sustained as a result of damage to the property of a third party with whom he has a contract. He was denied recovery by the court.

⁴²¹ [1877-78] 3 App. Cas 279.

rendered more onerous, or have secured to themselves advantages which are rendered less beneficial by the damage done to the chattel, have a right of action against the wrongdoer although they have no immediate or reversionary property in the chattel, and no possessory right by reason of any contract attaching to the chattel itself, such as by lien or hypothecation.

. . . .

I will ask your Lordships to reject this contention of the Respondents' counsel.⁴²²

The difference is said to lie in the question of whether the loss is related to physical injury or not. A typical example is where a contractor, employed to construct building and during the construction works damaged an important power cable. This had led to cutting power supplies to a commercial business district. As a result businesses of the district, suffered severe financial losses. Whereas the owners of the power cable may recover damages, the financial losses sustained by these businesses were termed as pure economic loss and therefore denied.⁴²³

3. TORT OF NEGLIGENCE AND ITS LIMITED REMEDY

3.1 INTRODUCTION

As we have seen above, the essence of tort was that if anyone infringes the right another he should be made to pay for it. Moreover, in early English law, the basis of the American common law, requirement for this conduct was absolute, and a person who acted in a wrongful manner was liable for any resulting damages irrespective of any relationship between himself and the defendant. Since presumably, defendant's obligation was owed to the whole world. In cases where a breach of this right is intentional or reckless, the absolute wrong concept still remains and courts make no distinction between the categories of loss, they readily oblige the plaintiff. For example, in America there is a general tort doctrine that remedies any intentional harm without a

⁴²² Id at p. 289.

⁴²³ See *Byrd v. English*, 43 SE [1903] 419, for a classic example of lost of profit arising from damage to electric supply lines.

just cause.⁴²⁴ Where, on the other hand, the damage is negligently caused the moral imperative becomes weaker and courts were more reluctant to allow recovery. That was how the courts began to develop the duty concept under the tort of negligence.

The law of negligence, thus, obliges one to act with reasonable care and prudence. When one fails to so act or meet a recognized minimum standard of prudence, he would be said to be negligent. If his action or omission causes harm to another person, he will be held liable to compensate the victim for the harm sustained.⁴²⁵ It must be noted however that negligence law ‘takes no cognizance of carelessness in the abstract.’⁴²⁶ According to Lord MACMILLAN:

It concerns itself with carelessness only where there is a duty to take care and where failure in that duty has caused damage. In such circumstances carelessness assumes the legal quality of negligence and entails the consequences in law of negligence. The cardinal principle of liability is that the party complained of should owe to the party complaining a duty to take care, and that the party complaining should be able to prove that he has suffered damage in consequence of a breach of that duty.⁴²⁷

Negligence, it must be emphasized, covers positive actions as well as omissions. Hence, one can be liable for acting negligently or negligently failing to act. There are many torts other than negligence but they are usually identified by the particular interest they seek to protect. For example, nuisance is known to protect against interference with the claimant’s use and enjoyment of land, while defamation protects against damage to his or her reputation. By contrast, negligence is not tied to a particular relationship, type of harm, or the protection of a particular interest. In fact “the categories of negligence are never closed”.⁴²⁸ This however, is by no means underestimating the importance of other class of torts but that they are beyond the purview of this thesis.⁴²⁹ Let us now look at

⁴²⁴ WITTING, C., “Of Principle and Prima Facie Tort” *Monash University Law Review*, 25, 1999, p. 295.

⁴²⁵ SHENOY, A. (2001) in XIAO-WEI, N., *Recovery of Pure Economic Loss...*, op. cit., p. 17

⁴²⁶ *Donoghue v. Stevenson* [1932] AC 562

⁴²⁷ Id at p. 618.

⁴²⁸ See the dictum of Lord MACMILLAN id at p. 619.

⁴²⁹ See BAKER, C. R. & PRENTICE, D., “The Origins of Auditor Liability to Third Parties under United States Common Law”, *Accounting History*, 13, 2008, p. 167, accessed February 9, 2010 at <http://ach.sagepub.com/cgi/content/abstract/13/2/163>, where the learned authors argued that “the heart of tort law [nonetheless] is based on personal injury arising from negligence.” Id.

tort of negligence and the duty concept as applied by courts in pure economic loss cases.

3.2 THE LEGAL REQUIREMENTS IN A NEGLIGENCE ACTION

In order to prove the negligence of the defendant and therefore warrant the defendant being held responsible for the injuries suffered by the claimant, the claimant must establish the following:⁴³⁰

Duty of care: Does the defendant owe the claimant a duty of care?

Breach: Has the defendant breached that duty?

Damage: Had that breach caused a legally recognized damage to the claimant?

3.3 THE CONCEPT OF DUTY OF CARE

Duty is simply defined as a legally recognized relationship between the defendant and the plaintiff, and due to this relationship the defendant is obligated to act with care towards the plaintiff.⁴³¹ FLEMING defines duty of care as, “an obligation, recognized by law, to avoid conduct fraught with unreasonable risk of danger to others.”⁴³² Lord ATKIN was very explicit from the onset that not every instance of carelessness which results into harm will lead to liability under tort law. Whether a duty of care exists in any set of circumstances is a question of law.⁴³³ In pure economic loss cases, in particular, it is a requirement that poses difficulties for the claimant. In fact courts themselves have found it difficult to articulate a clear test for assessment of duty of care.⁴³⁴ The development of the duty of care can be traced to the seminal English case of *Donoghue v. Stevenson*,⁴³⁵ where Lord ATKIN propounded the first general rule for determining duty of care.

⁴³⁰ MULLIS, A. & OLIPHANT, K., Torts, op. cit., p. 10. This list may sometimes be up to five.

⁴³¹ Id at p. 17.

⁴³² FLEMING, J., *The Law of Torts* (9th edition, LBC Information Services, 1998), p. 149.

⁴³³ Invariably the outcomes of claims in negligence depend on whether the defendant owed a duty to the plaintiff, and that the defendant has breached such a duty by failing to exercise reasonable care in fulfilling the duty, and finally, the plaintiff has suffered injuries as a result of the breach. In other words, under the law of negligence, it is the existence duty that transforms factual responsibility for careless injury into a legal responsibility.

⁴³⁴ KHOURY, L., Liability of Auditors..., op. cit., p. 429.

⁴³⁵ [1932] AC 562

The Plaintiff, Mrs. Donoghue was purchased a ginger beer by her friend. The ginger beer was contained in an opaque bottle, which prevented the contents from being viewed clearly. After consuming some of the product, remains of a decomposed snail emerged from the bottle during a refill. The Plaintiff suffered from resulting nervous shock and gastroenteritis, which she blamed on the accident, and sought damages against the manufacturers.

The Plaintiff could not sue the shopkeeper with whom she never had a contract because the drink was bought for her by a friend, and neither could she have had any remedy on contract against the manufacturers of the ginger beer.⁴³⁶ She therefore sued the manufacturers for negligence. The court then had to decide whether the defendants owed a duty of care to the plaintiff in the absence of any contractual relationship.

The House of Lords decided the matter in the affirmative with Lord ATKIN going on to formulate what is now commonly known as the ‘neighbor principle’ and undoubtedly the bedrock of the English law of tort.⁴³⁷ The main thrust of his Lordship’s dictum is reproduced below:

The liability for negligence, whether you style it such or treat it as in other systems as a species of “culpa,” is no doubt based upon a general public sentiment of moral wrongdoing for which the offender must pay. But acts or omissions which any moral code would censure cannot in a practical world be treated so as to give a right to every person injured by them to demand relief. In this way rules of law arise which limit the range of complainants and the extent of their remedy. The rule that you are to love your neighbor becomes in law, you must not injure your neighbor; and the lawyer’s question, Who is my neighbor? Receives a restricted reply. You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbor. Who, then, in law is my neighbor? The answer seems to be – persons who are so closely and directly affected by my act that I ought reasonably to

⁴³⁶ Until this time, the usual remedy for damage caused by a defective product would be an action in contract, but this was unavailable to the Plaintiff, because the contract for the sale of the drink was between her friend and the shopkeeper.

⁴³⁷ MULLIS, A. & OLIPHANT, K., *Torts*, op. cit., p. 10.

have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.⁴³⁸

The significant of this case lies in the fact that it established a separate cause of action in negligence. It also made proximity of relationship between the Plaintiff and Defendant and the reasonable foreseeability of injury the basis of duty. Above all, it is regarded as the foundation of modern negligence law upon which later developments are built. As rightly observed by Lord REID in *Home Office v Dorset Yacht Co.*:⁴³⁹

Donoghue v. Stevenson . . . may be regarded as a milestone, and the well-known passage in Lord Atkin's speech should I think be regarded as a statement of principle. It is not to be treated as if it were a statutory definition. It will require qualification in new circumstances. But I think that the time has come when we can and should say that it ought to apply unless there is some justification or valid explanation for its exclusion.⁴⁴⁰

Generally, the courts have little difficulty in finding that a duty of care exists in cases where the damage suffered is personal or to property. In such cases the nature of the damage, like consumption of faulty product, demonstrates some closeness between the parties at some point. However, where the damage is pure economic loss, the courts have found this principle inappropriate for fear of inordinate liability. This reason prompted the courts to restrict the application of the 'neighbor principle' to only cases of physical damage. This concern was well articulated by Lord PEARCE in *Hedley Byrne & Co Ltd v Heller & Partners Ltd*⁴⁴¹ as follows:

Negligence in words creates problems different from those of negligence in act. Words are more volatile than deeds. They travel fast and far afield. They are

⁴³⁸ *Donoghue v. Stevenson* [1932] AC 562 at p. 579-80.

⁴³⁹ [1970] AC 1004

⁴⁴⁰ *Id.* In this particular case, Lord REID went on and applied the same principle but with more emphasis on foreseeability, as follows:

[T]he taking by the trainees of a nearby yacht and the causing of damage to the other yacht which belonged to the respondents ought to have been foreseen by the borstal officers as likely to occur if they failed to exercise proper control or supervision; in the particular circumstances the officers *prima facie* owed a duty of care to the respondents...*Id.*

⁴⁴¹ [1964] AC 465

used without being expended and take effect in combination with innumerable facts and other words. Yet they are dangerous and can cause vast financial damage.⁴⁴²

Hedley Byrne was the first case decided on grounds of pure economic loss in the context of negligent misstatement. The fact of the case succinctly, is that the Appellants sought to recover their loss after granting credit on the strength of the report given by the Respondent bank to their bank which turned out to be incorrect. The House of Lords held that a duty did exist, but the Appellants were unsuccessful because of an express disclaimer on the credit report which stated “in confidence and without responsibility.”

The decision by the House of Lords that duty of care may exist in these circumstances was seen as an extension of the *Donoghue* principle, and may be applicable to other facets of economic loss as well. However, the *Hedley Byrne* principle was later interpreted to apply exclusively to negligent misstatement cases.⁴⁴³ This position was better expressed by WINN LJ, in *SCM (United Kingdom) Ltd v. WJ Whittall & Son Ltd*:⁴⁴⁴

Apart from the special case of imposition of liability for negligently uttered false statements, there is no liability for unintentional negligent infliction of any form of economic loss, which is not itself consequential on foreseeable physical injury or damage to property.⁴⁴⁵

Since the decision of the House of Lords in *Hedley Byrne* the tendency has been to categorize the circumstances in which recovery is permissible by reference to the type of conduct which has occasioned the loss. Where the loss results from a negligent act or omission, the general view was to disallow recovery. Thus the right to recover pure economic loss in tort, not flowing from physical injury, does not extend beyond the situation where the loss is sustained through reliance on negligent misstatement as established in the case of *Hedley Byrne*.

⁴⁴² Id at p. 534.

⁴⁴³ KHOURY, L., *Liability of Auditors...*, op. cit., p. 430.

⁴⁴⁴ [1971] 1 QB 337

⁴⁴⁵ Id.

Another effort to create a general test applicable to all types of harm was initiated by the House of Lords in *Anns v. Merton London Borough Council*.⁴⁴⁶ The case was about structural defects in a property leased by the Plaintiff. The Plaintiff sued the builders as well as the local authority in negligence for approving the building plans. Lord WILBERFORCE, in his speech, attempted to move the principles for determining duty of care to the next level and expounded that:

Through the trilogy of cases in this House, *Donoghue v Stevenson*, *Hedley Byrne & Co Ltd v Heller & Partners Ltd* and *Home Office v Dorset Yacht Co Ltd*, the position has now been reached that in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages. First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a *prima facie* duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise.⁴⁴⁷

The above decision laid down a two-stage test for determining duty of care. First, did the parties satisfy the neighbor test – in other words, was the claimant someone to whom the defendant could reasonably be expected to foresee a risk of harm? If the answer was yes, a *prima facie* duty of care is presumed. Second, was there any policy consideration for excluding that presumption? If there were no policy considerations that stand against establishing a duty of care, then a duty would be imposed.

Soon *Anns* decision came under criticism for its expansion of the situations in which a duty of care could arise, and therefore in the scope of negligence. In fact, the growth in liability for negligence this case provoked set all sorts of alarm bells ringing.

⁴⁴⁶ [1978] AC 728

⁴⁴⁷ *Id* at p. 751-52

Eventually, the problems of insuring against the new types of liability, and the way in which tort seemed to be encroaching on areas traditionally governed by contractual liability, led to a rapid judicial retreat and, in a series of cases, the judiciary began restricting new duties of care. Lord KEITH in *Yuen Kun Yeu v. Att-Gen of Hong Kong*⁴⁴⁸ took the bait as he rejected the *Anns* test and articulated the issue as follows:

[T]he two-stage test formulated by Lord Wilberforce for determining the existence of a duty of care in negligence has been elevated to a degree of importance greater than it merits, and greater perhaps than its author intended [Their] Lordships consider that for the future it should be recognized that the two-stage test in *Anns* is not to be regarded as in all the circumstances a suitable guide to the existence of a duty of care.⁴⁴⁹

The *Anns* principle was finally laid to rest by the House of Lords in the case of *Murphy v. Brentwood District Council*,⁴⁵⁰ where their Lordships invoked the 1966 Practice Statement⁴⁵¹ and overruled *Anns*. The rejection of *Anns* case as a litmus test for duty of care soon paved the way for a new test set down by the same House of Lords in *Caparo Industries Plc v. Dickman*,⁴⁵² which is now regarded as definitive measure for determining the duty of care. The case itself is about negligent misstatement and the question is whether auditors could be held liable to investors who detrimentally relied on their statement. The dictum of Lord Bridge is worth reproducing here:

[I]n addition to the foreseeability of damage, necessary ingredients in any situation giving rise to a duty of care are that there should exist between the party owing the duty and the party to whom it is owed a relationship characterized by the law as one of 'proximity' or 'neighborhood' and that the situation should be one in which the court considers it fair, just and reasonable that the law should impose a duty of a given scope upon the one party for the benefit of the other. But it is implicit in the passages referred to that the concepts of proximity and fairness embodied in these additional ingredients are not

⁴⁴⁸ [1988] AC 175

⁴⁴⁹ Id at p. 190-94

⁴⁵⁰ [1990] 2 All ER 908

⁴⁵¹ This is the authority which allows the House of Lords to depart from their own previous decisions.

⁴⁵² [1990] 2 A.C. 605

susceptible of any such precise definition as would be necessary to give them utility as practical tests, but amount in effect to little more than convenient labels to attach to the features of different specific situations which, on a detailed examination of all the circumstances, the law recognizes pragmatically as giving rise to a duty of care of a given scope. Whilst recognizing, of course, the importance of the underlying general principles common to the whole field of negligence, I think the law has now moved in the direction of attaching greater significance to the more traditional categorization of distinct and recognizable situations as guides to the existence, the scope and the limits of the varied duties of care which the law imposes.

As seen above, the *Caparo* case laid down a three-stage test for determining the duty of care viz., foreseeability of harm, proximity of relationship and fairness, justice and reasonableness (policy factors). Accordingly, in addition to establishing proximity and foreseeability, the claimant must also establish that it is just and reasonable to impose a duty of care. These tests may be classified as follows,

1. That harm was reasonably foreseeable to the claimant.
2. That there was a relationship of proximity between the claimant and defendant.
3. That under the circumstances of the case, it is fair, just and reasonable to impose a duty of care on the defendant.

The following paragraphs will elaborate more on these three tests.

3.3.1 FORESEEABILITY OF HARM

The foreseeability test requires that the claimant must be shown to fall within the class of persons put at risk by the defendant's failure to exercise due care. This rule derives its origins from the 'neighbor principle' enunciated by Lord ATKIN in *Donoghue v. Stevenson*.⁴⁵³ It requires a person in defendant's position to reasonably foresee that the act or omission he was contemplating would possibly affect the claimant or someone in his class. This test is necessary to be able to determine whether the defendant can reasonably foresee the negative consequence of his want of care to others. If he can so

⁴⁵³ [1932] AC 562

predict then he would be expected to take steps to avoid causing the harm. The rule serves to weed out claims that are far-fetched and so remotely removed from the defendant's negligence.⁴⁵⁴ Practical example of this test is found in case is *Langley v. Dray*,⁴⁵⁵ where the claimant was a policeman who was injured in a car crash when he was chasing the defendant, who was driving a stolen car. The Court of Appeal held that the defendant knew, or ought to have known, that he was being pursued by the claimant, and therefore in increasing his speed he knew or should have known that the claimant would also drive faster and so risk injury. Hence the defendant had a duty not to create such risks and he was in breach of that duty.

However, the most notorious elaboration of this rule is found in the judgment of CARDOZO J in the New York Court of Appeal case of *Palsgraf v. Long Island Railroad Co.*⁴⁵⁶ The plaintiff Mrs. Palsgraf was standing on a train platform when two men ran to catch a train. The second man who was carrying an apparently innocuous small package was help aboard by the guards. The man dropped the package which happened to contain fireworks. The box exploded and the shock of the explosion caused scales at the other end of the platform many feet away to fall, striking and injuring Palsgraf. In its judgment the majority of the court held that the railway employees owed no duty of care to the plaintiff as she was not a foreseeable victim of their negligence. Cardozo J explained:

One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended...The victim does not sue derivatively, or by right of subrogation, to vindicate an interest invaded in the person of another...He sues for a breach of a duty owing to himself.⁴⁵⁷

It must be added that the foreseeability requirement is not without criticism. Its detractors sustain that between innocent and careless injurer, the equities clearly favor the

⁴⁵⁴ MULLIS, A. & OLIPHANT, K., Torts, op. cit., p. 20.

⁴⁵⁵ [1998] 5 PIQR P314

⁴⁵⁶ 248 NY 339 (1928)

⁴⁵⁷ Id at p. 345- 46

former.⁴⁵⁸ Foreseeability has also been criticized for being manipulated and serves as means to obscure the policy considerations that are behind the rule in the first place.⁴⁵⁹ Accordingly, MULLIS & OLIPHANT sustain that in recent decisions the courts have adopted a better approach of distinguishing issues of legal policy from factual duty question, that is, the question of foreseeability.⁴⁶⁰

3.3.2 PROXIMITY OF RELATIONSHIP

The requirement that the defendant must be in close proximity with his victim, earlier equated with “foreseeability”,⁴⁶¹ has now assumed independent and central importance in the tort of negligence. Proximity literally means closeness, in terms of physical position. But more than closeness in time and space proximity is used as a legal term of art. Thus, it signifies a relationship, if any, between the defendant and the claimant or that the defendant is in a position to avoid harm to the claimant.⁴⁶² For example, Lord ATKIN was using the word ‘neighbor’, not to describe geographical closeness, but in terms of those we might reasonably anticipate as in danger of being affected by our actions if we are negligent.⁴⁶³ DEANE J in *Sutherland Shire Council v. Heyman*⁴⁶⁴ describes what proximity entails, thus:

It involves the notion of nearness or closeness and embraces physical proximity (in the sense of space and time) between the person or property of the plaintiff and the person or property of the defendant, circumstantial proximity such as an overriding relationship ... of a professional man and his client and what may (perhaps loosely) be referred to as causal proximity in the sense of the closeness or directness of the causal connection or relationship between the particular act or course of conduct and the loss or injury sustained. It may reflect an assumption by one party of a responsibility to take care to avoid or prevent injury, loss or damage to the person or property of another or reliance by one

⁴⁵⁸ FLEMING, J., *The Law...*, op. cit., p.159.

⁴⁵⁹ MULLIS, A. & OLIPHANT, K., *Torts*, op. cit., p. 21.

⁴⁶⁰ *Id.*

⁴⁶¹ Please see *Anns v. Merton London Borough Council* [1978] AC 728

⁴⁶² *Heaven v. Pender* (1883) 11 Q. B. D. 503 as per Brett M.R., as he then was, “whenever one person is by circumstances placed in such a position with regard to another, that everyone of ordinary sense who did think would at once recognize that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of the other, a duty arises to use ordinary care and skill to avoid such danger.” *Id.* at p. 510.

⁴⁶³ *Donoghue v. Stevenson* [1932] AC 562

⁴⁶⁴ (1985) 60 ALR 1

party upon such care being taken by the other in circumstances where the other party knew or ought to have known of that reliance. Both the identity and the relative importance of the factors which are determinative of an issue of proximity are likely to vary in different categories of case.⁴⁶⁵

Proximity, however, is far more complex and should not be regarded as having an immutable meaning but rather a generic name applicable to specific circumstances in order to determine the existence of duty in different types of cases. Consequently different proximity rules apply in different duty situations. For instance, it can be seen in that in typical negligence cases, like personal injury, proximity ipso facto adds very little for the determination of duty since foreseeability of harm sufficiently covers both of the requirements. In more problematic areas, however, “proximity imposes a more substantial hurdle.”⁴⁶⁶ This type of hurdle is more apparent in pure economic loss cases where the courts hold that for a defendant to be liable he must have voluntarily assumed a responsibility for the task at hand.

This of course does not mean that the claimant and the defendant must know each other, but that their circumstances must warrant that the defendant could reasonably be expected to foresee that his action could harm the claimant. As abundantly illustrated by Lord MORRIS in *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*:⁴⁶⁷

I consider that it follows and that it should now be regarded as settled that if someone possessing special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill, a duty of care will arise. The fact that the service is to be given by means of or by the instrumentality of words can make no difference. Furthermore, if in a sphere in which a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person takes it upon himself to give information or advice to, or allows his information or

⁴⁶⁵ Id at p. 55-56.

⁴⁶⁶ MULLIS, A. & OLIPHANT, K., *Torts*, op. cit., p. 22.

⁴⁶⁷ [1964] AC 465

advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise.⁴⁶⁸

Under this premise, it is the assumption of responsibility that fulfills the necessary proximity requirement. According to WITTING,⁴⁶⁹ the essential function of the proximity test is to identify whether the defendant was appropriately placed to avoid harm to the plaintiff. Thus, it refers to legal rules established by judicial precedents, which varies according to the circumstances of a particular case, which serve to place liability where it rightly belongs.

3.3.3 FAIRNESS, JUSTICE AND REASONABLENESS

A duty will only be recognized by courts when it is fair, just and reasonable in the circumstances of the case to hold the defendant liable to the claimant. These are non-legal considerations that may be economic, social, or ethical, which a judge may employ in deciding the outcome of a case. Policy factors play significant role in the law of negligence, particularly in relation to duty of care. Where proximity is said to be policy “crystallized” into a principle of law; fairness is “raw” policy. The test is whether a specific policy factor exists in the particular circumstances which should be used to deny a duty of care.

This essentially involves ‘pragmatic consideration’ by the courts whether it is just, fair and reasonable to impose a duty of care on the defendant, having regard to all the circumstances of the case. In the dual tests of foreseeability and proximity, judgment is based on factual evaluation while here the court weighs the balance between principle and policy considerations. Among other factors, ordinary reason and common sense are considered but the case is ultimately determined by reference to judicial value.

One case that demonstrate the application of policy is the case *Arthur JS Hall v Simons*,⁴⁷⁰ where the House of Lords was to determine whether or not to abolish advocates’ immunity from liability for his conduct of a case in court. Lord BROWNE-WILKINSON reasoned as follows:

⁴⁶⁸ Id at p. 502.

⁴⁶⁹ VAN BOOM, W. H., ET AL., *Pure Economic...*, op. cit., p. 114.

⁴⁷⁰ [2000] 3 AER 673

First . . . , given the changes in society and in the law that have taken place since the decision in *Rondel v Worsley* . . . , it is appropriate to review the public policy decision that advocates enjoy immunity from liability for the negligent conduct of a case in court. Second, that the propriety of maintaining such immunity depends upon the balance between, on the one hand, the normal right of an individual to be compensated for a legal wrong done to him and, on the other, the advantages which accrue to the public interest from such immunity. Third, that in relation to claims for immunity for an advocate in civil proceedings, such balance no longer shows sufficient public benefit as to justify the maintenance of the immunity of the advocate.⁴⁷¹

Judges in determining liability for pure economic loss were influenced by extra-legal consideration. An approach that has been called into question in recent years, with the House of Lords casting doubt as to the appropriateness of using policy consideration in legal reasoning.⁴⁷² There is a considerable divergence of opinion over the justifiability of policy consideration in judicial undertaking. One fact that is supreme however, is the difficulty of taking an extreme stance either way. While it will be naïve to deny policy consideration in determining legal questions, the application of blanket policy consideration regardless of legal principle will certainly leave much to the discretion of individual judge. I find the position enunciated by Stephen J in *Caltex Oil (Australia) Pty Ltd v. The Dredge Willemstad*⁴⁷³ to be a middle ground:

Policy considerations must no doubt play a very significant part in any judicial definition of liability and entitlement in new areas of law, the policy considerations to which their Lordships paid regard in *Hedley Byrne* are an instance of just such a process and to seek to conceal those considerations may be undesirable. That process should, however, result in some definition of rights and duties, which can then be applied to the case in hand, and to subsequent cases, with relative certainty. To apply generalized policy considerations directly, instead of formulating principles from policy and applying those

⁴⁷¹ *Rondel v. Worsley* [1969] 1 AC 191, was the case where the House of Lords affirmed that barristers and advocates do not owe a duty of care in negligence to their clients, because their overriding duty is to the court and course of justice.

⁴⁷² [1983] AC 400 Lord SCARMAN regarded policy considerations as being non-justiciable but Lord EDMUND-DAVIES described this proposition as 'novel as it was startling'. See note 1 supra at 427.

⁴⁷³ [1976] 136 CLR 529

principles, derived from policy, to the case in hand, is... to invite uncertainty and judicial diversity.⁴⁷⁴

Finally, all the three elements of reasonable foreseeability, proximity, and justice and fairness have to be considered in determining whether a duty of care should be said to exist in any particular case. How these factors come to play and their degree shall be seen in the following chapters of this thesis.

4. AMERICAN VIEW AND THE ADVENT OF ‘BRIGHT LINE RULE’

It is instructive to point out from the onset that the American tort law is in theory not one, but many, as each member state may decide its own private law, including tort as it sees fit. In practice however, the states do not move complete independence on this or any tort issue,⁴⁷⁵ for reasons of their shared source of common law. A heritage that had helped to provide a confluence for American private law, as common law, continues to transcend state boundaries.⁴⁷⁶ That notwithstanding, judicial pronouncements have sometimes being varied across the commonwealth. In fact a fundamental factor for the introduction of the Restatements of Torts was to bring harmony to the judicial system.

This must not however be confused with application of the *stare decisis* doctrine, (the binding effect of an earlier judgment to subsequent ones on similar facts) where judges “create” the law in common law jurisdictions, as represented by America. In contrast with the Spanish legal system and the civil law family, to which it belongs, where the *jus commune* from which Spanish law is derived contained substantive rules considered as complete and coherent. The work of a judge is merely reduced in principle to applying the law. The written law here fundamentally reigns supreme.

In America the economic loss rule is generally associated with uncontrollable and unforeseeable floods of claim to which there may be no end.⁴⁷⁷ Subject to a few exceptions recovery for pure economic loss is strictly denied. In practice American

⁴⁷⁴ Id. at p. 567.

⁴⁷⁵ GRUNING, D., “Pure Economic Loss in American Tort Law: An Unstable Consensus”, *American Journal of Comparative Law*, 64 2006, 188.

⁴⁷⁶ Id. at p. 189.

⁴⁷⁷ The seminal case in this respect is *Ultramares Corporation v. Touch, Niven & Company* (1931) 255 NY 170, where J: Cardozo contended that accountant should not be held liable by third parties for a negligent audit because “the defendants would be exposed to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.”

courts have developed a *bright line rule* very similar to the *English exclusionary rule*.⁴⁷⁸ The bright line rule like the exclusionary rule is a judge made rule, which places emphasis on physical damage as prerequisite for recovery of economic loss. It is a clearly defined legal rule created by judicial precedents, which must be applied once those factual situations are met, and leaves no room for varying interpretation. Its opposite rule is the *balancing test rule*, where the courts will look at the surrounding circumstances of the case to determine the result. The application of this rule is reaffirmed in a recent class action case of *In re: Bertucci Contracting Company, LLC*,⁴⁷⁹ where a vessel owned by Bertucci collided with a bridge owned by the Louisiana State. The damage to the bridge led to its closure to vehicles and pedestrians for several days.

Residents of the area filed for a class action claiming damages for loss of use of their properties, and loss of income due to the lack of access to their homes and businesses during the bridge closure. The court held that the plaintiffs' action must fail because they have failed prove any property damage they had sustained and that interference with access was not physical damage. The bright line rule applied here was a rule of the federal maritime law, known as Testbank rule,⁴⁸⁰ which specifically denies recovery to non-proprietors for economic loss.

A similar decision was reached in the seminal U.S. Supreme Court case of *Robins Dry Dock v. Flint*,⁴⁸¹ where time-charterers sought to recover for loss of use of a chartered vessel while it was being detained for repairs which were necessitated in consequence of the defendants' carelessness in permitting the propellers to become fouled. HOLMES J held that while intentional-interference to bring about a breach of contract may give rise to a cause of action, there could be no recovery for such loss:

⁴⁷⁸ This is a privity rule that prevents a stranger from benefitting from a contract unless at least, he can show that it was intended for his direct benefit. It essentially excludes any loss that is not related to person or property from being compensated.

⁴⁷⁹ C.A. 12-30780 (5th Circuit March 22, 2013)

⁴⁸⁰ *State of Louisiana ex Rel Guste v. MV Testbank*, 752 F.2d 1019 (5th Cir. 1985)

⁴⁸¹ 275 U.S. 303 [1927]

As a general rule a tort to the person or property of one man does not make the tortfeasor liable to another merely because the injured party was under a contract with that other, unknown to the doer of the wrong.⁴⁸²

As seen in the above quoted dictum, the U.S. Supreme Court followed the traditional common law view that in a tort action there cannot be liability on the part of the defendant without violation of a duty owed to the plaintiff. According to common law courts, this duty is owed only to those who have a right in *rem* with respect to the damaged property. Therefore, those who have a right of use of such a property by virtue of a contractual right are excluded from the protection of tort of negligence. Thus, when plaintiff cannot connect his economic loss to a physical injury or damaged property to the acts or omissions of defendants, courts will deny recovery. In *Stevenson v. East Ohio Gas Co. Ltd.*,⁴⁸³ Morgan J made it quite clear that the ruling in *Robins*⁴⁸⁴ was based on the same utilitarian logic which had been employed by English and Common law courts as quoted below:

To permit recovery of damages in such cases would open the door to a mass of litigation which might very well overwhelm the courts so that in the long run while injustice might result in special cases, the ends of justice are conserved by laying down and enforcing the general rule as is so well stated by Mr. Justice Holmes in *Robins Dry Dock & Repair Co v. Flint*.⁴⁸⁵

Federal as well as state courts in the United States have faithfully applied the broad interpretation of the “bright line rule” to the great majority of pure economic loss cases. Only a few exceptions have been admitted. Moreover, to cap it all, the rule has been further incorporated into the *Restatement (Second) of Torts*.⁴⁸⁶ Whereas outside the United States, especially in Europe and Canada, the doctrine of pure economic loss is well-covered as any in torts, pure economic loss “remains a backwater within the discourse of the American tort law.”⁴⁸⁷ Commentators have never agreed on how to classify the cases that fall within its ambit. They even disagree on what to call the

⁴⁸² Id.

⁴⁸³ [1946] 73 NE 2d 200

⁴⁸⁴ 275 U.S. 303 [1927]

⁴⁸⁵ 275 U.S. 303 [1927]

⁴⁸⁶ See Restatement (Second) of Torts Section 766 (c).

⁴⁸⁷ BUSSANI, M. & PALMER, V. V., *Pure Economic...*, op. cit., p. 96.

rule.⁴⁸⁸ In fact it was not embraced as a genuine area of enquiry by the American legal community.⁴⁸⁹

5. PURE ECONOMIC LOSS UNDER SPANISH LAW

5.1 AN “EXTRANJERO” CONCEPT

The Spanish legal situation paints a different picture, unlike in the United States where the doctrine merely begs for merited recognition, Spanish tort law is neither familiar with a separate category of pure economic loss, nor does the concept itself appear in any Spanish legal scholarship dealing with tort law.⁴⁹⁰ Only very recently has it appeared in Spanish legal discourse, borrowed from the international debates, to refer to some very specific problems.⁴⁹¹ Hence in Spanish law, liability for pure economic loss is not a problem. The Spanish Civil Code, a system of personal responsibility based on the principle of fault, is delicately managed by courts by shifting around the arteries of causation and injury, focusing on the wrongful act rather than the nature and extent of the plaintiff's right.⁴⁹² Therefore, it can be safely asserted that classification of rights in terms of their importance to determine their recoverability prevalent in common law countries is *ipso facto* non-existent under Spanish law.

The tenor of section 1902 of the Spanish Civil Code (CC) which provides that “the person who by action or omission causes damage to another by fault or negligence is obliged to repair the damage caused”, is a general clause whose wording allows the assumption of liability for any act that causes any kind of damage and does not limit the scope of rights and interests it seeks to protect.⁴⁹³ In fact, Spanish law, in principle, compensates all legitimate interests with no further distinction. Any injury, physical, non-physical or economic is *prima facie* recoverable under this system.

⁴⁸⁸ Exclusionary rule is preserved in the United States for criminal procedure only and has no room in private litigation.

⁴⁸⁹ The doctrine is rarely discussed by American scholars and “is indeed often ignored by courts”. See VAN BOOM, W. H., ET AL., *Pure Economic...*, op. cit., p. 96.

⁴⁹⁰ VAN BOOM, W. H., ET AL. (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 62.

⁴⁹¹ Id. It was especially employed in the areas of negligent misstatement and product liability.

⁴⁹² Id at p. 63.

⁴⁹³ Id at p. 65.

This position however is by no means a carte blanche for all shades of pure economic loss. Hence, under this system as well, the debate over the extent and limitation of liability is ever present. Like their common law counterparts, Spanish courts have had the necessity to limit liability to its proximate consequences and thereby excluding the damages that are remote.⁴⁹⁴ As rightly observed by DIEZ-PICAZO as follows:

Se plantea el problema de fijar límites oportunos a la responsabilidad, el principal de los cuales es el de la selección de las consecuencias dañosas, cuya finalidad consiste en afirmar la responsabilidad en alguno de los casos y negarla en otros.⁴⁹⁵

In other words, Spanish courts have devised a method of keeping the floodgate shut as well.⁴⁹⁶ They usually employ causation elements to sort out recoverable from non-recoverable cases, and to restrict liability to a reasonable limit. This invariably takes the form of proof, where the damage suffered must be established to be certain and directly linked to the action or omission of the defendant. The elements Spanish courts use merit brief discussion below.

5.2 UNLAWFULNESS (ANTI JURÍCIDAD)

This is not a requirement as an element of proof under Section 1902 CC. According to MARTIN-CASALS & JORDI RIBOT, it was likely borrowed from Spanish criminal jurisprudence and legal scholarship.⁴⁹⁷ Although its exact application is hard to ascertain, courts usually make reference to unlawfulness as a breach of duty not to harm as enshrined under section 1902 CC. OLIVA BLÁZQUEZ is of similar opinion, the learned author traced unlawfulness requirement back to traditional Spanish doctrine that relates civil liability to an unlawful or illegal act, and its compensation is considered as a sort of reproach to breach of the law.⁴⁹⁸ It follows as well that, this has been the position of

⁴⁹⁴ DIEZ-PICAZO, L., *Derecho de Daños*, Ed. Civitas, Madrid, 2000, p. 332.

⁴⁹⁵ *Id.*

⁴⁹⁶ According to MARTIN-CASALS & JORDI RIBOT, the methods employed by Spanish courts are usually related to the tort element “damage”, in the sense that the damage suffered by the victim is not certain or has not been sufficiently proved, or to the element “causation”, in the sense that, in the case at hand, the causal link between the action or omission of the tortfeasor and the resulting damage has not been established.” VAN BOOM, W. H., ET AL. (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 63.

⁴⁹⁷ MARTIN-CASALS, M. & JORDI RIBOT, I. in VAN BOOM, ET AL., *Pure Economic...*, op. cit., p. 62.

⁴⁹⁸ OLIVA BLÁZQUEZ, F., “Responsabilidad Civil de los Jueces y Magistrados por Ignorancia Inexcusable”, 2010, p. 37, accessed September 26, 2010 at www.indret.net

the Spanish Supreme Court in some notable cases, like the Supreme Court case of October 6 2006. In this case the court held that for a conduct to be liable for compensation it must be unlawful. A similar opinion was reached in the *locus classicus* of March 17, 1981, where the court reasoned as follows:

[A]unque nuestro Código Civil, siguiendo al francés (y a diferencia del austríaco, el alemán, el suizo, el italiano y el portugués), no menciona expresamente la nota de antijuridicidad en su artículo 1902, no cabe duda que debe verse la misma no sólo en la actuación ilícita caracterizada por la falta de diligencia contraria a una disposición legal, sino también en consecuencias de actos lícitos no realizados con la prudencia que las circunstancias del caso requerían.⁴⁹⁹

According to ROCA TRÍAS, unlawfulness referred to in Spanish tort law and reflected under article 1902 CC does not need to proceed from an illegal act, *strictu sensu*, but must be understood in the context of *alterum non laedere*, the general norm in tort law that prevents harm.⁵⁰⁰ This argument found judicial support in the Supreme Court case of February 24, 1993 as follows:

[D]icho tipo de responsabilidad, que establece el artículo 1902 del Código Civil, viene condicionada por la exigencia de que el acto dañoso sea antijurídico por vulneración de la norma, aún la más genérica ("alterum non laedere"), protectora del bien agraviado, y culpable, por omisión de la diligencia exigible, que comprende no sólo las prevenciones y cuidados reglamentarios, sino todos los que la prudencia imponga para prevenir el evento.⁵⁰¹

However, a good part of Spanish legal scholars do not consider unlawfulness as a necessary requirement for the proof of liability. In this sense, DIEZ-PICAZO noted that unlike the Italian and Portuguese Civil Codes that predicate tort liability on illicit act, a plethora of Spanish judicial pronouncements seems to indicate that tort liability does

⁴⁹⁹ SSTs de 17 de marzo de 1981 (RJ 1981\1009).

⁵⁰⁰ DIEZ-PICAZO, L. & GULLÓN BALLESTEROS, A., *Sistema de Derecho Civil*. 9ª ed. Madrid: Tecnos, 2005. Vol. II, p. 544.

⁵⁰¹ STS de 24 de febrero de 1993 (RJ 1993\1251).

emanate from acts that are completely legal or in the exercise of one's legal right.⁵⁰² The learned author argued further that the continued allusion to *alterum non laedere* under Spanish law only serves to create more confusion on the doctrine of *antijuricidad*. His reflections are reproduced below:

La alusión, tanta veces repetida, al brocardo o aforismo *alterum non laedere*, resulta enormemente perniciosa e incrementa la confusión. En su origen cuando formaba parte del *tria iuris praecepta*, de ULPIANO, era poco más que un precepto moral, es decir, un principio generalísimo, absolutamente necesitado de concreción o concretización. En términos estrictamente jurídicos, hay que proceder a esta concreción del *non-laedere* que es un concepto de daño explícito, a menos que se incurra tajantemente en la anfibología que poco más o menos sería decir que un daño es antijurídico porque se viola una regla de no causar un daño antijurídico.⁵⁰³

In a similar vein, Professor PANTALEÓN PRIETO argued that unlawfulness is an unnecessary addendum to the explicit provision of section 1902 of the Spanish Civil Code. PANTALEÓN PRIETO noted “muchas veces se generan daños sin que exista una norma prohibitiva que los sancione; que algunas veces se lesionan bienes que no constituyen auténticos derechos subjetivos y que otros planteamientos adolecen de una absoluta vaguedad.”⁵⁰⁴ He argues further that the general liability clause enshrined under section 1902 sufficiently covers all torts without the necessity of *alterum non laedere*. Therefore tort liability in Spain is compensated not because of its unlawfulness but for the damage suffered by the claimant. As sustained by PANTALEÓN as follows:

La inexistencia de conexión funcional entre las normas sobre responsabilidad extracontractual y las normas penales impide considerar como elemento del supuesto de hecho de las primeras la antijuricidad basada en el desvalor de la conducta. Y la ausencia de dicha conexión entre las normas sobre responsabilidad extracontractual y las normas de atribución impide lo propio para la antijuricidad basada en el desvalor del resultado, siendo evidente que no

⁵⁰² DÍEZ-PICAZO, L., *Derecho de...*, op cit., p. 290

⁵⁰³ Id at p. 292.

⁵⁰⁴ PANTALEÓN PRIETO, F. (1991) in ROCA TRÍAS, E. & NAVARRO MICHEL, M., *Derecho de Daños*. 6ª ed. Valencia: Tirant lo Blanch, 2011. p. 32.

hay una norma que prohíba de manera absoluta dañar a otro. Por tanto, debe rechazarse que el supuesto de hecho de las normas sobre responsabilidad civil extracontractual requiera un elemento de antijuricidad.⁵⁰⁵

Accordingly, injury is remedied not for being an unlawful act but as a consequence of fault or damage caused by the tortfeasor, although not illegal per se.

5.3 FAULT (CULPA)

This is the reason why damage or injury is compensated under Spanish tort law. In the civil law legal tradition, as in common law, the existence of injury alone does not warrant a recovery unless such is demonstrated to have occurred as result of the tortfeasor's fault or negligence. This, according to DIEZ-PICAZO, requires the proof of fault or negligence in the action or omission that produces the damage.⁵⁰⁶ This, in essence, signifies establishing a causal link between the action or omission and the personality of the tortfeasor. Even as such, the court would still have to evaluate the circumstances of the case to determine not only the fact that the defendant has caused the damage but whether or not to hold the defendant legally responsible for the damage.

DIEZ-PICAZO argued further that there is an implicit reproach in this assessment,⁵⁰⁷ where the defendant is held responsible for not doing enough to avoid the damage or otherwise the damage would not have happened. The application of fault under Spanish law is more or less like that of foreseeability under the American common law. It amounts to acting in a negligent or improvident way.⁵⁰⁸ The development of culpa is amply illustrated in Spanish Supreme Court case, STS of June 10 2003, where it was held as follows:

⁵⁰⁵ PANTALEÓN, F., "La Prevención a través de la Indemnización: Los Daños Punitivos en Derecho Norteamericano y el Logro de sus Objetivos en el Derecho Español", *Derecho del Consumo: Acceso a la Justicia, Responsabilidad y Garantía*, Ministerio de Sanidad y Consumo, Consejo General del Poder Judicial, Madrid, 2001, p. 31 fn. 5.

⁵⁰⁶ DIEZ-PICAZO, L., *Derecho de...*, op cit., p. 351.

⁵⁰⁷ Id.

⁵⁰⁸ HERNANDEZ, F. R. (1999) in VAN BOOM, W. H., ET AL. (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 65. PEÑA LÓPEZ argues "la calificación como culposa de la conducta de una persona depende esencialmente de que ésta haya realizado o no un comportamiento objetivamente menos diligente que aquél que le exige el Derecho." See PEÑA LÓPEZ, F., *La culpabilidad en la responsabilidad civil extracontractual*, Edit. Comares, Granada, p. 442.

La concepción clásica de la culpa se apoya invariablemente como elemento indispensable en la omisión de la diligencia exigible al agente. La posición moderna, en cambio, caracteriza la culpa por notas distintas de esa falta de diligencia y llega a hablar de una culpa social o culpa sin culpabilidad. El sentido clásico de la culpa civil parte de identificarla con negligencia, concepto que se opone al de diligencia; basado todo ello en un criterio subjetivo. La culpa es desviación de un modelo ideal de conducta: modelo representado, una vez por la “fides” o “bona fides”, y otra por la “diligentia” de un “pater familias” cuidadoso.

En la culpa el elemento intelectual del dolo (previsión efectiva) queda sustituida por el de “previsibilidad”, o sea, la posibilidad de prever, y el elemento volitivo queda reemplazado por una conducta negligente: no se ha creído efectivamente el efecto, pero se ha debido mostrar mayor diligencia para evitarlo.

La previsibilidad del resultado es el presupuesto lógico y psicológico de la evitabilidad del mismo. La diligencia exigible ha de determinarse en principio según la clase de actividad de que se trate y de la que puede y debe esperarse de persona normalmente razonable y sensata perteneciente a la esfera técnica del caso.⁵⁰⁹

It envisages the defendant's ability to predict the outcome and consequences of his action or omission. Where he does not take steps to avoid the conduct called into question, he is bound to compensate the plaintiff. Where on the contrary, the damage is unpredictable to the defendant such would be a motive for his exoneration.⁵¹⁰ As observed by DIEZ-PICAZO as follows:

En materia de responsabilidad por daños, especialmente cuando se trata de responsabilidad por culpa, sólo se responde de aquéllos que hubieran podido debido preverse. De este modo, la previsibilidad es una condición de la

⁵⁰⁹ STS de 10 de junio 2003 (RJ 2003/6008).

⁵¹⁰ Article 1105 of the Spanish Civil Code is clear that there cannot be liability for unforeseeable or inevitable acts. “nadie responderá de aquellos sucesos que no hubieran podido preverse, o que, previstos, fueran inevitables.”

responsabilidad y, a la inversa, la imprevisibilidad es un factor de exoneración.⁵¹¹

This is by no means construed as a duty requirement as in common law. Nonetheless, OLMO GARCÍA concluded that the same result might be reached through the application of causation in law.⁵¹²

In determining the conduct of the defendant the courts apply the test enshrined under article 1104 thus: “La culpa o negligencia del deudor consiste en la omisión de aquella diligencia que exija la naturaleza de la obligación y corresponda a las circunstancias de las personas, del tiempo y del lugar. Cuando la obligación no exprese la diligencia que ha de prestarse en su cumplimiento, se exigirá la que corresponda a un buen padre de familia.” This article has been duly interpreted by the court as follows:

La medida de la diligencia exigible es variable para cada caso; según el artículo 1104 del Código Civil, dependerá de la naturaleza de la obligación y ha de corresponder a las circunstancias de las personas, del tiempo y del lugar. Según el mismo artículo que cuando la obligación no exprese la diligencia que ha de prestarse en su cumplimiento, se exigirá la que correspondería a un buen padre de familia. Es, pues, una medida que atiende a un criterio objetivo y abstracto. Exigible según las circunstancias es la diligencia que dentro de la vida social puede ser exigida en la situación concreta a personas razonables y sensatas correspondientes al sector del tráfico o de la vida social cualificadas por la clase de actividad a enjuiciar. Según este criterio objetivo, ha de resolverse la cuestión de si el agente ha obrado con el cuidado, atención o perseverancia exigibles, con la reflexión necesaria y el sacrificio de tiempo precisos. Al respecto no es pues decisiva la individualidad del agente, sino las circunstancias que determinarán la medida necesaria de diligencia y cautela. Apunta también a un criterio de valoración de la culpa civil la facultad de moderación de la responsabilidad que procede de diligencia, concedida a los Tribunales según los casos por el artículo 1103 del Código Civil. Pero también ha de tenerse en cuenta un aspecto

⁵¹¹ DIEZ-PICAZO, L., *Derecho de...*, op. cit., p. 361.

⁵¹² VAN BOOM, W. H., ET AL., (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 65.

subjetivo, en cuanto al sujeto que obra le es posible prever las circunstancias del caso concreto.⁵¹³

In another case, the Spanish Supreme Court cited with approval the Principles of European Tort Law, as it adopts the reasonable man test encapsulated therein. The relevant part of the judgment reads:

[E]n los trabajos preparatorios de los “Principios de Derecho europeo de la responsabilidad civil”, actualmente en curso, se define el “Estándar de conducta exigible” como “el de una persona razonable que se halle en las mismas circunstancias, y depende, en particular, de la naturaleza y el valor del interés protegido de que se trate, de la peligrosidad de la actividad, de la pericia exigible a la persona que la lleva a cabo, de la previsibilidad del daño, de la relación de proximidad o de especial confianza entre las personas implicadas, así como de la disponibilidad y del coste de las medidas de precaución y de los métodos alternativos” (artículo 4: 102. -1).⁵¹⁴

5.4 CERTAINTY AND DIRECTNESS

Under the Spanish law, a plaintiff in an action for damages in tort must satisfy a high standard of proof that requires certainty as well as directness of damage.⁵¹⁵ In other words, there cannot be recovery in the absence of a real and existing damage. It was held in the judgment STS of April 9 1996 (RJ 1996/4182) that for a damage to be recoverable it must be shown to be existing at the time of the commencement of the legal action. In this sense, OLIVA BLÀQUEZ argues that “simple logic dictates that an

⁵¹³ STS de 10 junio de 2003(RJ 2003/6008). The same court held in the judgment STS de 11 de junio de 2007 (RJ 2007/3570) thus, “según reiterada doctrina jurisprudencial es esencial para generar culpa extracontractual, requisito de previsibilidad del hombre medio con relación a la circunstancias del momento, no en abstracto, en que no puede estimarse como previsible lo que no se manifiesta con constancia de no poderle ser.”

⁵¹⁴ STS de 17 de Julio de 2007 (RJ 2007/4895). The English version is quoted for ease of reference thus: “The required standard of conduct is that of the reasonable person in the circumstances, and depends, in particular, on the nature and value of the protected interest involved, the dangerousness of the activity, the expertise to be expected of a person carrying it on, the foreseeability of the damage, the relationship of proximity or special reliance between those involved, as well as the availability and the costs of precautionary or alternative methods.” Art. 4:102. (1).

⁵¹⁵ It is relevant to point out here that although the Spanish Civil Code is silent on the proof of damage, such provision is to be found in the Civil Procedure Code, (Ley de Enjuiciamiento Civil) section 217 (2), which provides thus; Corresponde al actor y al demandado reconviniendo la carga de probar la certeza de los hechos de los que ordinariamente se desprenda, según las normas jurídicas a ellos aplicables, el efecto jurídico correspondiente a las pretensiones de la demanda y de la reconvención. Thus, as held in STS of February 22, 2003 (JUR 2003\198549) proof of a particular fact lies on the party who alleges that fact.

action for recovery of damages should only prosper on the proof of the existence of such damage.”⁵¹⁶ This view concurs with the decision of the Spanish Supreme Court STS of February 21, 2003 (RJ 2003/2135) where the court concluded that:

Dice la sentencia de 31 de Enero de 2002, siguiendo la doctrina constitucional (S. de 17-7-1995), que la carga de la prueba corresponde al reclamante del daño cuando le resulta disponible la misma. [...] Al faltar tal presupuesto necesario no puede prosperar la acción por culpa extracontractual.⁵¹⁷

A similar conclusion was reached in the case STS February 10, 2009 (J2009/50847), where an HIV patient initiated this action against the hospital authorities for failure to inform her of the condition earlier. Her claim was refused by the court for her inability to prove the damage she suffered as a result. The court concluded thus, “en el proceso (...), siquiera sea de forma indiciaria, cuáles son los perjuicios concretos, singulares, tangibles (...) que le ha causado la tardanza en la toma de conocimiento de la tenencia del virus del SIDA”. The damage must also be present not hypothetical, as held in STS of July 20, 2009 (RJ 2009\3161) that “gastos de fisioterapia, clases de natación [y otros], teniendo en cuenta que se trata de unos daños, perjuicios y gastos futuros hipotéticos, que por tal circunstancia no pueden ser objeto de una condena de futuro”.

The application of certainty in Spanish law is more apparent in the area of causation. Spanish courts' requirement in causation is very strict and must be established to the level of certainty. Although, it has been held that certainty of causal link need not be always absolute,⁵¹⁸ it should however be reasonably certain.⁵¹⁹ This is demonstrated in the case STS of February 8 2000 (RJ 2000/1235), where the court reiterated that “in the sphere of causal relationship there is no room for deductions, guesswork or

⁵¹⁶ OLIVA BLÁZQUEZ, F., “Comentario a la Sentencia de 7 de Julio de 2008”, *Cuadernos Civitas de Jurisprudencia Civil*, 80, 2009, p. 621. In the same sense, the PETL provides that: “Damage must be proved according to normal procedural standards. The court may estimate the extent of damage where proof of the exact amount would be too difficult or too costly.” Art. 2:105.

⁵¹⁷ STS de 21 de febrero de 2003 (RJ 2003/2135).

⁵¹⁸ Please see STS de 2 de marzo de 2000 (RJ 2000/1304) where absolute certainty was held to be the measure of proof, but depending on the circumstances of a particular case, the Spanish Supreme Court would weigh the type of certainty required as seen in the case STS de 30 de noviembre de 2001 (RJ 2001\9919) where the court concluded that “la determinación del nexo causal no puede fundarse en conjeturas o posibilidades, no siempre se requiere la absoluta certeza, por ser suficiente (en casos singulares) un juicio de probabilidad cualificada”.

⁵¹⁹ STS de 23 de diciembre de 2002 (RJ 2003\914).

probabilities, only evidential certainty is sufficient.” Thus, the standard of proof based on the “balance of probabilities” obtained in common law jurisdictions is insufficient under this system.⁵²⁰

These two requirements originally associated with the burden of proof in contract are perhaps the Spanish law version of reasonability and fairness tests. It creates a margin for maneuver where courts can weigh the veracity of individual cases to choose which merit recovery and which not. The application of these elements will lead to similar result like of those systems where rights are classified as protected and non-protected, although it does not relate to property damage in the American sense.

6. TAXONOMY OF STANDARD ECONOMIC LOSS CASES

Legal scholars have differed on how to classify cases of pure economic loss, especially, cases of unintentional harm. As such, there has been a number of different taxonomy of economic loss cases by different authors. One example is the taxonomy by BUSSANI et al. that came up with four groups: ricochet loss, transferred loss, closures of public service and infrastructures, and reliance upon flawed information or professional services.⁵²¹ HERBERT BERNSTEIN, on the other hand, found only three groups: intellectual services, defective products, and interference with use of resources.⁵²² This thesis will devise a taxonomy based on the classifications by both BUSSANI and ANITA BERNSTEIN,⁵²³ albeit, with some important modifications to describe the economic loss cases.

6.1 CONTRACT-LIKE RELATIONS

This type of economic loss, also referred to as relational loss, arises where a physical injury to the person or property of a tortfeasor leads to a financial loss incurred by the plaintiff. Thus, the direct victim suffers physical damage to his property, while the plaintiff sustains financial loss as a secondary victim. In these kind cases there is a

⁵²⁰ MARTIN-CASALS, M. & JOSEP SOLÉ F., “Medical Liability in Spain”, in KOCH, B. A., (ed.), *Medical Liability in Europe: Tort and Insurance Law*, De Gruyter, Berlin, 2011, p. 516.

⁵²¹ BUSSANI, M., PALMER, V. V. & PARISI, F., “Liability for Pure Financial Loss in Europe: An Economic Restatement”, *AM. J. COMP. L.*, 51, 2003, p. 118.

⁵²² BERNSTEIN, H., “Civil Liability for Pure Economic Loss under American Tort Law”, *AM. J. COMP. L.*, 46, 1998.

⁵²³ BEINSTEIN, A., “Keep It Simple: An Explanation of the Rule of No Recovery for Pure Economic Loss”, *Ariz L. Rev.*, 48, 2006, pp. 782-83.

condition precedent to recovery which requires that the plaintiff's loss must stem from physical injury to his person or to property of which he was the owner or was in possession at the time the damage was suffered. It is not sufficient for the plaintiff to show that he had contractual rights and obligations in respect of the damaged property (meaning he was not the owner or in possession) and that he had suffered financially as a result. The case of *Spartan Steel & Alloy Ltd v. Martin & Co. (Contractors) Ltd*,⁵²⁴ clearly demonstrates the operation of this requirement to bar recovery of pure economic loss.

In this case, the defendant contractors had negligently caused a power failure; as a result the plaintiff had suffered loss when power supply to his electric furnace was interrupted. The loss suffered was in respect of material which had been in the furnace at the time and which had solidified during the power cut. The plaintiff also suffered loss due to the processing time lost during this period. The court held that the plaintiff could claim the profits which he could have made by selling the final product had the material not been damaged by the interruption to the process. This was loss which was causally linked to physical damage to the plaintiff's own property. However, the loss of profits due to the failure to process material during the power cut did not stem from any damage to the plaintiff's property. It was true that the defendant's negligence had caused damage to the electric cable which then led to the interruption in power supply but the cable was not the property of the plaintiff. The loss of profits under the second category was therefore pure economic loss.

Another example in this category of pure economic loss is where the plaintiff is not the direct victim of physical injury or damage. "Here, *C* causes physical damage to *B*'s property or person, but a contract between *A* and *B* (or the law itself) transfers a loss that would ordinarily be *B*'s onto *A*," BUSSANI et al. elucidate.⁵²⁵ These are mostly contracts that separate property rights from use or risk bearing, like leases, sales, insurance agreements and other contracts. These cases present a clear illustration of how the plaintiff can suffer an injury in absence of proprietary right or human body due to defendant's negligence. As is typical of bright line rule, American courts out rightly

⁵²⁴ [1973] QB 27, following an earlier case on broadly similar facts, *SCM (United Kingdom) Ltd v. WJ Whittall & Sons Ltd* (1970) 1 QB 337.

⁵²⁵ BUSSANI, M., ET AL., Economic Restatement, op. cit., p. 118.

deny compensation for this line of cases.⁵²⁶ Courts are cognizant of the fact that a star athlete may be injured by some negligence from a tortfeasor that could lead to revenue loss to the team, but these issues should be better left within the realm of contract.⁵²⁷ Consequently, case law has in a plethora of cases “rejected separate actions by insurance companies against tortfeasors for harm to the insured persons.”⁵²⁸

Spanish law does not distinguish between loss arising from damage to one’s own property and loss arising from damage to the property of another. Once there is fault and damage accompanied by causal link, there is bound to be compensation. If Spanish courts would allow or deny any recovery, it must be on the individual merit of a case not by operation of the law. For instance, factory workers were allowed compensation for damage to their work place which led to their temporary dismissal.⁵²⁹ However, where destruction of rented premises led to the determination of a lease recovery was denied by the Spanish Supreme Court for absence of causation.⁵³⁰ There are no legal provisions regarding claim by a creditor for death or injury of a debtor caused by the defendant but it seems, taking cue from Italian law Spanish courts are disposed to award damages especially in cases where personal service is essential.⁵³¹

In fact Spanish courts have at many occasions considered transferred loss cases in ways other than contractual, especially the state claims for injury sustained by public servants or law enforcement agents in their course of duty. In one case where an officer was injured as a result of the tortfeasor defendant’s fault compensation was denied, the court argued that the state has failed to prove any additional expense incurred in filling the post vacated by the victim.⁵³² In the same vein a claim by a company to recover for the continued payment of salary to an injured worker for traffic accident was also rejected. It was held that there was no link between the accident and the company’s workers’ compensation scheme.⁵³³ These decisions were however criticized for not being in line

⁵²⁶ BEINSTEIN, A., Keep it Simple..., op. cit., p. 773.

⁵²⁷ The leading authority in this area is the case of *Phoenix Professional Hockey Club v. Hirmer*, 502 P.2d 164 (Ariz. 1972) where the court dismissed plaintiff’s suit for payments to a substitute is; when defendant’s negligence renders plaintiff’s goalkeeper unable to play.

⁵²⁸ BEINSTEIN, A., Keep it Simple..., op. cit., p. 784.

⁵²⁹ STS de 30 de mayo de 1986 (RJ 1986/2918).

⁵³⁰ STS de 28 de febrero de 1983 (RJ 1983/1079).

⁵³¹ FERNANDEZ AREVALO, F. (1996) in VAN BOOM, W. H., ET AL., (eds.), Pure Economic Loss: Tort..., op. cit., p. 64.

⁵³² STS de 29 de setiembre 1986 (RJ 1986/4922).

⁵³³ See VAN BOOM, W. H., ET AL. (eds.), Pure Economic Loss: Tort..., op. cit., p. 75.

with Spanish general doctrine of liability.⁵³⁴ Please note that pay continuation statutes are virtually non-existent in America.

6.2 PRODUCT DEFECTS AS ECONOMIC LOSS

The rule against recovery of pure economic loss extends to pure economic loss suffered as a result of defects in goods supplied. As noted earlier, the notion of pure economic loss by design or default has escaped the attention of American scholars. The area of product liability marks an exception to this generalization. It involves claims by product owners against sellers for defects that lead to pure economic loss. This ranges from cost of repair to replacement and also lost of profits between the time of report and repair or replacement.⁵³⁵ It is in this context that American courts have become familiar with the pure economic loss rule.

In the wake of the industrial development in the early nineteenth century, American courts needed an answer to numerous suits under tort of negligence brought by product owners against suppliers. The courts responded by creating strict liability rule that allows product owners to recover damages for physical harm suffered. But the courts have distinguished between damage to the “defective product” itself and damage to “other property”, the former is not compensated.⁵³⁶ Thus when the defendant supplies defective goods and these defects lead to physical injury or damage to other property of the plaintiff, there is no problem with the recovery.

Having consolidated strict liability for product defects as a course of action under American tort law,⁵³⁷ product owners began to invoke the strict liability rule in claims for pure economic loss in defective products not necessarily brought about by physical

⁵³⁴ See PANTALEÓN PRIETO, F., “Comentario al artículo 1902 Cc”, en PAZ-ARES RODRIGUEZ, C., Díez-PICAZO, L., BERCOVITZ, R. & SALVADOR CODERCH, P., (dir.), *Comentario del Código civil*, Ministerio de Justicia, Secretaría General Técnica, Madrid, 1993, p. 1991.

⁵³⁵ Please see the U.S. Supreme Court case of *The Potomac* (105 U.S. 630), where the held that lost of profits are recoverable during products repairs. The court expounded as follows:

...the owners of the injured vessel are entitled to recover for the loss of her use, while laid up for repairs. When there is a market price for such use, that price is the test of the sum to be recovered. When there is no market price, evidence of the profits that she would have earned if not disabled is competent; but from the gross freight must be deducted so much as would in ordinary cases be disbursed on account of her expenses in earning it; in no event can more than the net profits be recovered by way of damages; and the burden is upon the libellant to prove the extent of the damages actually sustained by him. Id at p. 631.

⁵³⁶ See *Central Bit Supply v. Waldrop Drilling & Pump*, 717 P.2d 35 (Nev. 1986)

⁵³⁷ The Restatement (second) on Torts s. 402A (1965) played a significant role in this development.

harm. This line of argument was brought to test in the leading case of *Santor v. A & M Kargheusian, Inc.*,⁵³⁸ where the New Jersey Supreme Court answered in the affirmative that pure economic loss is indeed recoverable in a strict liability action. The decision was not meant to last as a few months later the Supreme Court of California held that strict liability doctrine does not apply to pure economic loss cases.⁵³⁹

Finally, in 1986 the Supreme Court of the United States of America brought down the curtain on product owners in *East River S.S. Co. v. Transamerica Delavan*,⁵⁴⁰ by placing its seal of approval behind the no liability in tort for pure economic losses caused by product defects, which eventually became the *majority rule*⁵⁴¹ in the US. In this case the plaintiffs, charterers of four oil supertankers, brought a strict liability products suit against the turbine manufacturer, seeking solely economic damages resulting from alleged design and manufacturing defects that caused the supertankers to malfunction while on the high seas. The court held that the pure economic loss doctrine barred tort claims in circumstances where quality of such products was at question, the court elaborates:

But either way, since, by definition, no person or other property is damaged, the resulting loss is purely economic. Even when the harm to the product itself occurs through an abrupt, accident-like event, the resulting loss due to repair costs, decreased value, and lost profits is essentially the failure of the purchaser to receive the benefit of its bargain -- traditionally the core concern of contract law.⁵⁴²

⁵³⁸ 207 A 2d 305 (NJ 1965).

⁵³⁹ *Seely v. White Motor Co.*, 403 P.2d 145 (Cal. 1965)

⁵⁴⁰ 476 US 858 (1986).

⁵⁴¹ The rule is so referred to because it is applied in the largest number of states in the U.S.

⁵⁴² *East River S.S. Co. v. Transamerica Delavan* 476 US 858 (1986), at p. 870. This rule is eventually applied in the largest number of states in the U.S., and hence referred to as "majority rule." However, it is worthy of note that in 1998 The American Law Institute adopted a new element of the Restatement 3d of Torts, entitled Products Liability. In it the Institute was faced with some unanswered questions, including those related with economic loss rule. This time, after more than a quarter of a century, the Institute provided under Section 21, that harm to persons or property subject to tort recovery may include economic loss, provided they fall under categories:

Harm to the plaintiff's person;

Harm to the person of another when harm to the other interferes with an interest of the plaintiff protected by tort law;

Harm to the plaintiff's property other than the defective product itself.

Product owners having failed to extend the strict liability rule to pure economic loss now turned to tort and began to file actions for pure economic loss under negligence law.⁵⁴³ Early response to the new course of action was mixed. Some courts found reason in allowing recovery for pure economic loss under negligence when there was no remedy under strict liability rule.⁵⁴⁴ But other courts rejected this argument,⁵⁴⁵ in the belief that it will be untenable to allow recovery for pure economic loss under tort law when contract and warranty have provided a better framework to resolve those issues. By the end of the last century recovery for pure economic loss in negligence as well as in strict liability had become almost a settled law in the United States.⁵⁴⁶ This happened, of course, subject to necessary limitations applied by courts to the particular circumstances of the cases. Thus a claimant will be entitled to compensation for expense incurred during the course of repair or replacement and a possible lost of profit.⁵⁴⁷

It must be noted however, that the application of the rule in America varies according to the state concerned. The *minority rule*⁵⁴⁸ essentially rejects the application of the pure economic loss doctrine. It allows a plaintiff to recover in tort for pure economic loss without limitations. The minority view is followed loosely by only a handful of states like New Jersey and California. The rest of the country follows either the majority rule or the *intermediate rule*. The intermediate rule is similar to the majority rule, except that it allows for tort recoveries under certain limited circumstances, attempting to differentiate between the disappointed consumer and the endangered consumer. Thus a consumer disappointed with the performance of a product and consumer whose life or

The Institute goes on to justify the rationale behind the exception under Comment A to Section 21 as below:

First, products liability law lies at the boundary between tort and contract. Some categories of loss, including those often referred to as 'pure economic loss' are more appropriately assigned to contract law and the remedies set forth in Articles 2, and 2A of the Uniform Commercial Code. When a code governs a claim, its 4 provisions regarding such issues as statute of limitation, privity, notice of claim, and disclaimer ordinarily govern the litigation. Second, some forms of economic loss have traditionally been excluded from the realm of tort law even when the plaintiff has no contractual remedy for a claim. Id.

⁵⁴³ SCHWARTZ, G. in BUSSANI, M. & PALMER, V. V. (eds.), *Pure Economic...*, op. cit., p. 98. See also *Berg v. General Motors Corp.*, 555 P 2d 818 (Wash. 1976).

⁵⁴⁴ Id.

⁵⁴⁵ Please see *Moorman MFG. Co. v. National Tank Co.*, 435 NE 2d 443 (Ill. 1982)

⁵⁴⁶ See *Alloway v. General Marine Industries, LP*, 695 A 2d 264 (NJ 1997)

⁵⁴⁷ SCHWARTZ, G. in BUSSANI, M. & PALMER, V. V. (eds.), *Pure Economic...*, op. cit., p. 98

⁵⁴⁸ This rule has the lowest following across the United States' jurisdictions.

limb is endangered. One example is the sudden and calamitous failure of a product or product failures which prove dangerous to the consumer.⁵⁴⁹ The *intermediate rule* will allow recovery in such situations as an exception to the pure economic loss rule, while the *majority rule* will not.

In Spain, product liability as a distinct area of law became known after the passage of the Consumer Protection Act of 1984.⁵⁵⁰ Until the coming into force of this Act, what may be considered as product liability disputes are dealt with under the general principles of contract and tort liability found under the Spanish Civil Code. Spanish courts, generally, apply rules of liability found in article 1101 CC, and more specifically, the rules governing latent product defects enshrined under article 1486 CC, and later the provisions under articles 1902 and 1903.4, dealing with tort liability.⁵⁵¹ All consumer protection laws in Spain, like the Consumer Protection Act of 1984, Product Liability Act of 1994 as well as the current law in force, General Consumer Act of 2007, are interpreted in the light of the general contract and tort law provisions of the Civil Code.⁵⁵²

Claimants for damages for product defects in Spain have used the general liability provisions obtainable under the Civil Code with some relative successes. As evidenced by the Supreme Court case STS of February 12, 1931 [Col. Leg. Num. 124], where a buyer of second hand car with latent steering column defect was allowed to rescind the contract under article 1486 CC. Even though, article 1257 CC restricts contract to the privity of parties and their heirs, claimants were still able to enforce contracts against third party manufacturers. This was the case, for instance, in STS of December 29, 1978 [Col. Leg. Num. 447], where the Spanish Supreme Court indirectly applying the French doctrine of *action directe*, side-stepped the provision of article 1257 in favor of article 1101, and held the manufacturer liable for supplying a dangerous product to the seller who was in privity with the claimant.⁵⁵³ However, it is worthy of note that the Supreme Court later overruled this decision in the case STS of November 14, 1984, where the

⁵⁴⁹ These are cases where products are inherently dangerous, especially, in situations where the consumer or others are put at 'unreasonable risk of injury'.

⁵⁵⁰ MARTIN-CASALS M. & JOSEP SOLÈ, F., in WHITTAKER, S., (ed.), *The Development of Product Liability* Cambridge University Press, 2010, p. 234.

⁵⁵¹ Id at p. 241.

⁵⁵² Id at p. 243.

⁵⁵³ Id at p. 242.

court held that the law of tort is the more appropriate avenue provided by law for this line of cases.⁵⁵⁴

Apart from the above examples, tortious liability for defective product did not become entrenched into Spanish law until when the courts began to apply the provisions of the Consumer Protection Act of 1984.⁵⁵⁵ The first case to apply this law was STS of May 29, 1993. In this case the claimant suffered burns as a result of explosion and ignition of a bottle of benzene he used to clean clothes. The Spanish Supreme Court applying this Act came to the right conclusion and found the manufacturer liable, albeit wrongly applying article 26 instead of article 28 the Act that more appropriately fits the case.⁵⁵⁶

Like its American counterpart, Spanish law views the arena provided by contract law as best for risk distribution between two contracting parties. Therefore guarantee, exclusion clauses and limitation are best let be established by parties where necessary, and where per chance they neglect to do so, the relevant regulation on the material prevails. In this case, the applicable law is Article 9 of EC Directive 85/374. Here article 142⁵⁵⁷ of the Spanish Consumer law as amended. In practice, the law operates almost the same way like the situation under American law. In fact Spanish legal writers and commentators have drawn inferences on the American system on several occasions.⁵⁵⁸ As important as these consumer protection Acts are, they only supplement the existing contract and tort remedies already in existence under the Spanish law.

6.3 WRONGFUL DEATH

This category includes cases of death or injury to one person that brought about economic loss to his family. In a wrongful death action in America, a relative of a person who died as a result of negligent conduct has two fronts for recovery of pure

⁵⁵⁴ STS de 14 de noviembre de 1984 (RJ 1984/5554). According to MARTIN-CASALS & JOSEP SOLÈ, this decision was the first to be classified by the court as manufacturer liability and recognized the manufacturer's duty to the consumer of a product sprayed with a highly toxic insecticide. See WHITTAKER, S., (ed.), *The Development...*, op. cit., p. 245.

⁵⁵⁵ WHITTAKER, S., (ed.), *The Development...*, op. cit., p. 245.

⁵⁵⁶ *Id* at p. 247-48.

⁵⁵⁷ Real Decreto Legislativo 1/2007, de 16 de noviembre, por el que se aprueba el texto refundido de la Ley General para la Defensa de los Consumidores y Usuarios y otras leyes complementarias.

⁵⁵⁸ WHITTAKER, S., (ed.), *The Development...*, op. cit., p. 265.

economic loss. First under survival statute, second an action for wrongful death.⁵⁵⁹ The survival statute allows the representative of a dead plaintiff to proceed with litigation on behalf of the deceased person, as if she had not died. Wrongful death, by contrast, sites the loss in heirs rather than the deceased person herself. Courts measure the value of the lost life in two ways. First, they can count the amount of support that the deceased's dependents would have expected to receive but for the wrongful death. Second, they can estimate the amount of savings the deceased would have accumulated but for the wrongful death, and presume that she would have left her estate to these family members. A spouse can also maintain a cause of action for an injury to her husband,⁵⁶⁰ likewise a mother for injury to her children.⁵⁶¹

Spanish courts on the other hand recognize dependents' rights in cases of wrongful death without any a priori restriction of the class of relatives entitled to recover. This is encapsulated in the civil liability law which has a very wide coverage.⁵⁶² Accordingly, Spanish courts, would award compensation both for pecuniary loss indirectly sustained and non-pecuniary loss for the pain and suffering of the victim's relatives. The latter is measured according to the proximity of kinship. Judicial pronouncements in this category show the magnanimity of the Spanish courts as below indicated:

Parents but not heirs to the victim were awarded a non-pecuniary compensation for their pain and suffering for the loss of a son,⁵⁶³ court awarded compensation to the widow and son of a victim of work accident.⁵⁶⁴ Other persons in this category also include, the fiancée of the deceased,⁵⁶⁵ the step son,⁵⁶⁶ the girl who lived with the deceased and took care of her,⁵⁶⁷ old people's home where the deceased was living⁵⁶⁸ and the religious community the deceased belonged to.⁵⁶⁹

⁵⁵⁹ See DOBBS, D. B., *The Law of Torts*, St Paul, MN: West Group, 2000, p. 803. Meanwhile, under the common law, these types of claims are not actionable by operation of the Latin maxim, *Actio personalis moritur cum persona*, or "personal (tort) action dies with the person."

⁵⁶⁰ See *Hittaffer v. Argonne Co.*, 183 F.2d 811 (D.C. Cir.).

⁵⁶¹ See SUSAN, G. R. (1989, p. 354).

⁵⁶² See tables I & II, Real Decreto Legislativo 8/2004, de 29 de octubre, por el que se aprueba el texto refundido de la Ley sobre responsabilidad civil y seguro en la circulación de vehículos a motor.

⁵⁶³ STS de 20 de julio de 1995 (RJ 1995/5728)

⁵⁶⁴ STS de 22 de noviembre de 2002 (RJ 2003/510)

⁵⁶⁵ STS 4ª de 12 de marzo de 1975 (RJ 1975/1798)

⁵⁶⁶ STS de 2 de febrero de 1973 (RJ 1973/593)

⁵⁶⁷ STS de 10 de febrero de 1972 (RJ 1972/584)

⁵⁶⁸ STS de 31 de mayo de 1972 (RJ 1972/2728)

⁵⁶⁹ STS 2ª de 12 de junio de 1970 (RJ 1970/3500)

6.4 IMPEDIMENTS TO BUSINESS OPERATIONS

This category of pure economic loss has nothing to do with contract. It usually relates to harms sustained as a result of accidents which affect another's business expectations. In this class of cases, the defendant negligently causes damage to a source of some resource like water, heating, electric power, air conditioning and the like that is necessary for the plaintiff's business operations. The wrongful physical act here takes place in the property not owned by the plaintiff but only suffers the pure economic loss thereof. American courts generally do not admit this class of claim. It is in relation to the negligent interference type cases that the twin fears of indeterminate liability and unending litigation are at their most potent. In such cases the only factor which forms any connecting link between the plaintiff and the defendant is the accident itself and it is clear that the destruction or impairment of a road, bridge or public utility may have the effect of rendering the performance of many contracts either more onerous or impossible. One important case that exemplifies this class of cases is *People Express Airlines, Inc. v. Consolidated Rail Corp.*,⁵⁷⁰ where defendant's negligence caused a fire in a railroad yard which led the authorities to evacuate the plaintiff's airport terminal close by for fear of explosion from the fire. As a result the plaintiff suffered revenue loss for booking cancellations. The New Jersey Supreme Court out rightly rejected the plaintiff's claim for being "unaccompanied by property damage or personal injury."⁵⁷¹

Whereas tort of negligence is the predominant cause of action for most plaintiffs in economic loss cases, some litigants prefer actions in public nuisance. Under public nuisance law, plaintiffs who could demonstrate to have suffered a different kind of injury from that of the general public is bound to succeed.⁵⁷² Successful plaintiffs under this category, in claims for negligence as well as nuisance, were fishermen whose source of livelihood was destroyed.⁵⁷³

Other scenarios in this class include situations where a highway or a bridge is destroyed or where carelessness of the defendants leads authority to close an area where the plaintiff has his business. For example where a bridge is negligently damaged, resulting

⁵⁷⁰ 495 A.2d 107 (N.J. 1985)

⁵⁷¹ Id at p. 108.

⁵⁷² BERNSTEIN, A., Keep it Simple..., op. cit., p. 789.

⁵⁷³ *Louisian v. M/V Testbank*, 752 F.2d 1019 (5th Cir. 1985)

in loss of business to commercial establishments on an island which is temporarily cut off from trade, recovery was denied.⁵⁷⁴

Spanish courts have considered cases on similar fact situations albeit, with mix results. For example, SAP ORENSE 16. 6. 1994 sentenced the city council of CARBALLINO to compensate the plaintiff for loss of earnings due to a power cut, which interrupted his business.⁵⁷⁵ The problem was caused by another stall owner who placed his stall on top of the grille of the power transformer. The council was held liable for *culpa in vigilando* under article 1903 CC.⁵⁷⁶ Then factory workers were allowed compensation for damage to their work place which led to their temporary layoff.⁵⁷⁷

6.5 FLAWED SERVICES

Under this category falls a professional and other service provider on whose services, skill and expertise the victim of pure economic loss places reliance. This scenario is brilliantly adumbrated by the dictum of Lord PEARCE in *Wilkinson v. Coverdale*⁵⁷⁸ thus:

In those cases there was no dichotomy between negligence in act and in word, nor between physical and economic loss. The basis underlying them is that if persons holding themselves out in a calling or situation or profession take on a task within that calling or situation or profession, they have a duty of skill and care. In terms of proximity one might say that they are in particularly close proximity to those who, as they know, are relying on their skill and care although the proximity is not contractual.⁵⁷⁹

Ordinarily, disappointed clients whose economic loss is attributable to the service rendered, may have a cause of action in contract “and, somewhat more controversially, deviations from a professional standard of care that cause losses to certain types of non clients.”⁵⁸⁰ For example, where the plaintiff was unable to inherit an estate by the negligence of a notary public who had failed to have a will properly attested to by the

⁵⁷⁴ *Rickards v. Sun Oil Co.*, 23 NJ. Misc. 89, 41 A.2d 267 (1945)

⁵⁷⁵ SAP ORENSE de 16 junio de 1994 (AC 1994/996).

⁵⁷⁶ VAN BOOM, W. H., ET AL., *Pure Economic...*, op cit., p. 75.

⁵⁷⁷ STS de 30 mayo de 1986 (RJ 1986/2918).

⁵⁷⁸ (1793) 1 ESP. 75

⁵⁷⁹ Id at p. 153-54

⁵⁸⁰ BERNSTEIN, A., *Keep it Simple...*, op. cit., p. 787.

required witnesses, the court held the attorney liable for financial loss even without privity.⁵⁸¹ Accountants, auditors, and other professional reviewers of financial conditions who do not fulfill relevant standards of care in their examination have been held liable to investors who relied on the accuracy of their reports as a condition of investment. Courts in this kind of situation are more liberal in granting remedies for causation of pure economic loss.

The Spanish situation is captured under article 26.2 of the Audit Law, where it stated that civil liability of auditors shall be proportionate to the loss they have caused to their client or third parties.⁵⁸² This provision should not be taken in isolation of judicial requirement of causation which in this instance is reliance. As such, notaries public will, in addition, to their contractual responsibility be also liable to third parties in tort. The starting point is *Article 705 (CC)* which reads as follows:

When an open will has been declared null on account of the fact that the formalities that are required in the case have not been followed, the notary that has authorized it shall be liable for the damage resulting thereof, if the deficiency stems from the notary's malice or from his inexcusable negligence or ignorance.⁵⁸³

Here a victim of avoided will would be entitled to recover the difference between what he inherited intestate and what is in the aborted will. In a case where the notary failed to properly identify the other contracting party who impersonated, the court held the notary liable.⁵⁸⁴

7. JUSTIFICATION FOR RESTRICTION OF PURE ECONOMIC LOSS

Contrary to orthodox view pure economic loss is recoverable as seen in cases of consequential loss and negligent services, it is only in cases of legitimate concern for disproportionate liability that courts on grounds of reasonability and common sense disallow compensation. Arguments abound for the rationale of no recovery rule and are

⁵⁸¹ The leading case here is *Biakanja v. Irving*, 320 P.2d 16 (Cal.1958).

⁵⁸² Art. 11. 1 Ley 19/1988, de Julio, de Auditoría de Cuentas.

⁵⁸³ For other types of scenarios, please see Articles 712 and 715 CC.

⁵⁸⁴ STS de 2 de diciembre de 1998 (RJ 1998/ 9156).

so common place that not repeating them would be of any disservice.⁵⁸⁵ The floodgates rationale nonetheless stands apart, especially, in cases of auditor liability and therefore merits some attention. Its bone of contention is built on the premise that allowing recovery in pure economic loss would place a great burden on the defendant and overwhelm the enterprise. PROSSER⁵⁸⁶ observed that “it is the business of the law to remedy wrongs that deserve it, even at the expense of “floodgate claims”, and it is pitiful confession of incompetence on the part of any court of justice to deny relief upon the ground that it will give the courts too much work to do”. On the consequential loss, BUSSANI & PALMER⁵⁸⁷ argue that “the central assertion that physical damage is different from financial damage because it is more contained and judicially manageable seems increasingly difficult to understand in view of today’s mass torts.....” Left to them any ‘intransigent argument’ that seeks to deny recovery to the victims of pure economic loss because they are so many is unsustainable in law.⁵⁸⁸

The above stance sound appealing. Indeed pure economic loss suffered in isolation is sometimes afforded no particular significance whereas pure economic loss suffered in conjunction with physical damage is virtually always a routine element of recoverable harm. Nonetheless, it is my thesis that the distinction between kinds of pure economic loss and physical loss is essentially a technical one. The tests of foreseeability, proximity and policy had but reveal an enduring concern about the limits of liability in tort that continues to present day. While none is satisfactory and for that matter, the combination of all, to a certain extent, they have been useful to administratively manage a balance between the desire to compensate the innocent plaintiff and the reluctance to subject the inadvertent defendant to an inordinate liability. These tests are not fool-proof however, as observed by Lord DENNING:

Sometimes I say: “There was no duty”. In others I say, “The damage was too remote”. So much so that I think the time has come to discard those tests which have proved so elusive. It seems to me better to consider the particular

⁵⁸⁵ Please see PARISI, F., PALMER, V.V. & BUSSANI, M., “The Comparative Law and Economics of Pure Economic Loss”, *International Review of Law and Economics* 27, 2007, for general discussion of the rationale for no recovery rule.

⁵⁸⁶ PROSSER, W. L., “Intentional Infliction of Mental Suffering: a New Tort”, *Michigan Law Review*, 37, 1939, p. 874.

⁵⁸⁷ BUSSANI, M. & PALMER, V. V., *Pure Economic...*, op. cit., p. 18.

⁵⁸⁸ *Id.*

relationship in hand, and see whether or not as a matter of policy, pure economic loss should be recoverable or not.⁵⁸⁹

It is very obvious that foreseeability test cannot hold true in the landmark case of *Ultramares*,⁵⁹⁰ where auditors were held not liable to investors, as auditors are well aware that class like those of investors would rely on their report for judgment. It is contended that this is sheer judicial policy to limit liability. All the tests are just the means to that end. The court's view in the case of *Biakanja v. Irving*⁵⁹¹ better illuminates this point:

The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.

In fact there are cases of pure economic loss that have received different treatment. Like the example of *J'Aire Corp. v. Gregory*,⁵⁹² where the plaintiff operated a restaurant at the Sonoma County Airport in facilities rented from the county. The defendant, a building contractor, entered into an agreement with the county to renovate the air conditioning and heating system in the restaurant and to install insulation. Because of the defendant's delays in construction, the plaintiff suffered an unanticipated loss of profits for which he brought suit against the builder. The court dismissed the defendant's objection that the case involved exclusively pure economic loss, and held that the plaintiff stated a claim for damages in tort for the lost profits.

It is also true that over the course of a century the courts have come to attach particular significance to the problem of personal injury that is now inconsistent with prospect of a widespread injury one single act of negligence can cause, like plane crash. These are

⁵⁸⁹ *Spartan Steel & Alloy Ltd v. Martin & Co. (Contractors) Ltd.* [1973] QB 27

⁵⁹⁰ [1931] 255 NY 170

⁵⁹¹ [1958] 49 Cal.2d 647

⁵⁹² [1979] 24 Cal.3d 799, 804

however, situations of common harm that cannot be equated with chain of commercial losses triggered by closure of a main road. Consider the view of CARDOZO J in *H.R. Moch Co. v. Rensselaer Water Co.*:⁵⁹³

The plaintiff would have us hold that the defendant, when once it entered upon the performance of its contract with the city, was brought into such a relation with everyone who might potentially be benefited through the supply of water at the hydrants as to give to negligent performance, without reasonable notice of a refusal to continue, the quality of a tort... We are satisfied that liability would be unduly and indeed indefinitely extended by this enlargement of the zone of duty.⁵⁹⁴

8. CONCLUSION

The lines have not always been clearly drawn and admittedly, some may be indefensible. As seen above, although the courts have deliberately formulated a device of limiting the scope of its recovery in some areas, “economic loss remains recoverable in a number of other situations.”⁵⁹⁵ Whilst it seems, generally, the courts do not like encouraging claims for pure economic loss there are confusing signals that sometimes make it difficult to predict with any certainty whether a claim will be successful or not. But “the central tendency to deny liability for categories of widespread loss has appealed to an enduring sense of fairness” in America as well as in Spain.⁵⁹⁶ But, how wide are the courts prepared to extend the parameters of duty and of economic loss in auditor liability cases, shall be discussed in the second part of this chapter on auditor’s liability.

⁵⁹³ [1928] 247 N.Y. 160

⁵⁹⁴ [1928] 247 N.Y. 160

⁵⁹⁵ Tort law

⁵⁹⁶ RABIN, R. L., *Tort Recovery ...*, op. cit., p. 1538.

PART 2

AUDITOR'S LIABILITY IN THE UNITED STATES AND SPAIN

1. LIABILITY UNDER CONTRACT

1.1 INTRODUCTION

Auditors' liability is for most part based on contract with their clients, and thereafter at common and statutory law. When an auditor is set to work for a client, a contract of employment is created, usually referred to as an engagement letter. Auditors' liability under a contract is governed by the terms set out by the parties themselves in the engagement letter. Albeit, some necessary terms may in appropriate circumstances be implied by law. Implied terms include inter alia, a term that a contracting party will exercise due skill and care in performing what he agrees to do.⁵⁹⁷ Inclusive in these terms is the requirement by the courts that parties in contract must abide by the "strictures of good faith and fair dealing." This entails that "neither party shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract."⁵⁹⁸ When the auditor fails to execute the requirements on the engagement letter, the auditor is said to be in breach. Breach of contractual terms naturally comes with consequences in damages. Damages are monetary compensatory instruments employed by courts to bring, the injured party as nearly as possible, to the same position as if the contract had been performed. These "consequences can and frequently do include pure economic loss."⁵⁹⁹

However, in a breach of contract action, the plaintiff must first of all establish before the court that there is an existing contractual relationship between himself and the defendant. This contractual relationship is known in law as privity. Privity signifies that the parties are bound by the contract to each other and owe each other a duty to perform in accordance with the terms of the contract. Parties outside the contract do not have *locus standi* to sue under the contract.

⁵⁹⁷ XIAO-WEI, N., Recovery of Pure Economic Loss..., op. cit., p. 24.

⁵⁹⁸ *Anthony's Pier Four, Inc. v. HBC Assocs.*, 411 Mass. 451 (SJC 1991)

⁵⁹⁹ XIAO-WEI, N., Recovery of Pure Economic Loss..., op. cit., p. 22.

When the plaintiff is the client for whom audit was done, it is relatively straight forward to determine whether the auditor is liable or not. However, when the party complaining is a third party who relies on an inaccurate audit report then the determination of liability becomes more complicated and treacherous. Common law courts had constantly denied remedy to ‘strangers’ both under contract law and under tort, perhaps, because tort as an equitable remedy must follow the law. As symbolized by the maxim, “equity follows the law.”

1.2 THE OVERLAP OF CONTRACT AND TORT: THE DOCTRINE OF PRIVITY

It is trite law that contractual remedies under common law were originally a preserve solely of parties that had furnished consideration. But more often than not common law courts had found a veritable instrument of justice in tort law to fill the vacuum left by the rigid requirement of consideration in contract. Yet, there still remain some borderline even though the two are said to perform separate functions.⁶⁰⁰ Tort law undertakes the protection of an existing wealth or health, while future gains falls within the purview of contract law. As observed by WEIR, ‘contract is productive, [while] tort is protective’.⁶⁰¹ Since physical losses are presumed to affect present wealth they are compensated in tort. On the contrary, when the loss is non-physical it would be denied except when contractually agreed.⁶⁰²

It is further argued that contract looks to the future and creates expectations that the law seeks to protect. Tort law on the contrary creates no future obligations. Its standard of duty of care is not deliberately derived from the will of the parties, but imposed from outside by reference to societal norms. Remedies in tort are therefore not designed for frustrated expectancies but for a loss sustained. However, put so broadly, this clearly does not always hold good. Professor ATIYAH,⁶⁰³ for example, noted that damages for personal injuries which are typical of tort often include an important element of compensation for lost expectations, i.e. the expectation to earn a living in the way which the injuries prevented.

⁶⁰⁰ Id. at p. 22.

⁶⁰¹ MARKESINIS & DEAKIN’S *Tort Law* 6th ed. Oxford: Clarendon Press, 2008, p. 19.

⁶⁰² XIAO-WEI, N., *Recovery of Pure Economic Loss...*, op. cit., p. 22.

⁶⁰³ ATIYAH, P. S., *The Rise and Fall of Freedom of Contract*, Oxford: Clarendon Press, 1979, p. 762-3.

On the other hand tort and contract may overlap, in that the same wrong may concurrently be both a breach of contract as well as a breach of duty which constitutes a tort.⁶⁰⁴ During the course of its development, there was a time when courts viewed tort and contract remedies as mutually exclusive.⁶⁰⁵ It has been submitted that when there is a contract, it may be raised to negate the possibility of an action in tort. As observed by Lord SCARMAN in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*⁶⁰⁶ as follows:

Their Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. This is particularly so in a commercial relationship. Though it is possible as a matter of legal semantics to conduct an analysis of the rights and duties inherent in some contractual relationships including that of banker and customer either as a matter of contract law when the question will be what, if any, terms are to be implied or as a matter of tort law when the task will be to identify a duty arising from the proximity and character of the relationship between the parties, their Lordships believe it to be correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, the right to determine their obligations to each other, and for the avoidance of confusion because different consequences do follow according to whether liability arises from contract or tort, e.g. in the limitation of action.⁶⁰⁷

The above stance, notwithstanding, the courts still maintain the tendency to allow claimants to choose whether to sue in contract or in tort, incidentally, a similar situation is obtained in Spain.⁶⁰⁸ Moreover some liabilities are inherently concurrent especially in the context of relationship with professionals like solicitors, accountants and doctors among others. But, as seen above, in third parties liability actions the doctrine of privity reigns supreme.

⁶⁰⁴ Cases of product defects reflect this situation.

⁶⁰⁵ *Bean v. Wade* (1885) 2 Times Law Reports 157, 158-9

⁶⁰⁶ [1986] AC 80

⁶⁰⁷ Id at p. 107.

⁶⁰⁸ See *Henderson and Others v. Merrett Syndicates Ltd and Others* [1994] All ER 506. Please see also *Midland Bank v. Hett Stubbs & Kemp* [1979] 1 Ch 384; where a solicitor was held liable to client in both contract and tort for negligently failing to register an option.

The doctrine of privity was first established in the 1842 English case of *Winterbottom v. Wright*.⁶⁰⁹ Succinctly, in this case, the plaintiff a mail coach driver on contract was injured when the coach collapsed. He sued the repairer of the coach who had a maintenance contract with the owner of the coach for negligence. The court held in “favor of the defendant, stating that there was no privity of contract between the plaintiff and defendant; therefore, no duty flowed to the plaintiff, and no liability existed.”⁶¹⁰ The court reasoned that holding the defendant liable outside the realm of contract could open a Pandora’s Box of liability:

There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operations of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.⁶¹¹

In other words, the law assumes that parties in contract acquire duties and liability from the contract, and shields them from liability outside the contract.⁶¹² Therefore any liability for negligence is to be determined in accordance with the principles of the law of contract, and is only enforceable by the contracting parties. This principle was reinforced in the case of *Seaver v Ransom*⁶¹³ as follows:

The general rule, both in law and equity was that privity between a plaintiff and a defendant is necessary to the maintenance of an action on contract. The consideration must be furnished by the party to whom the promise was made. The contract cannot be enforced against the third party, and therefore it cannot be enforced by him.⁶¹⁴

⁶⁰⁹ (1842) 152 ER 402

⁶¹⁰ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 79. See also GOMEZ, J., “Accountants’ Accountability to Non-Clients in Texas”, *Saint Mary’s Law Journal*, 35, 2003.

⁶¹¹ *Winterbottom v. Wright*, supra at p. 405.

⁶¹² GARRISON, A. F., Common Law Malpractice..., op. cit., p. 188.

⁶¹³ (1918) 224 NY 233

⁶¹⁴ This decision followed the precedent for the application of the doctrine of privity created by the United States Supreme Court’s decision in *Savings Bank v. Ward* [100 U.S. 195 (1879)] . The case involved an action by a bank which lent money for the purchase of real estate in reliance on a title report prepared by the defendant lawyer. The court denied the claim citing with approval the classic English case of

While it is trite that independent audit is primarily meant to provide information for the client on how well it is doing in its accounting functions, it also serves as an independent source of information from which third parties evaluate their own potential risks.⁶¹⁵ SEPTIMUS asserted that the accountant might have no contract with these persons, but their decisions and conduct are influenced by his findings,⁶¹⁶ and thereby make them the most obvious victims of a poorly conducted audit.⁶¹⁷ These persons, according to the AICPA,⁶¹⁸ apart from the client, are “credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce.”⁶¹⁹

Moreover, it can be safely asserted that in today’s information economy independent audit is used more by the public for evaluation of a company’s financial stability than by company’s officers for the purposes of internal management. This fact was judicially recognized by the United States Supreme Court in *United States v. Arthur Young & Co.*⁶²⁰ in no equivocal terms. Chief Justice WARREN BURGER expounds:

By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintains total independence from the client at all times and requires complete fidelity to the public trust.⁶²¹

Notwithstanding the above recognition, the question of auditor’s liability to third parties with no contractual privity still remains unsettled. Many persons who suffer loss from

Winterbottom v. Wright [152 Eng. Rep. 402 (Ex. 1842)] for the fear of the “absurd consequences” of indeterminate liability that would ensue if such plea was to be allowed.

⁶¹⁵ SEPTIMUS, J., Accountants’ Liability..., op. cit., p. 407.

⁶¹⁶ Id at p. 407 (citing HALLETT & COLLINS, 1968)

⁶¹⁷ SILICIANO, J. A., Trends in Independent..., op. cit., p. 342.

⁶¹⁸ Professional Standards, section 53.01.

⁶¹⁹ Id.

⁶²⁰ (1984) 465 U.S. 805

⁶²¹ Id at p. 817.

auditor's negligence may still be denied a remedy.⁶²² So with no recourse under contract, third parties who felt that they had been misled by negligent auditing readily sought resort in the tort of negligence. But unfortunately for them the line of judgments regarding auditor liability in the United States found mere negligence insufficient to warrant recovery for damages from auditors for performance of their professional responsibilities.⁶²³ As forebears of common law tradition, the United States' courts as well had kept liability for negligence between parties in privity.

With no duty from the auditor in the absence of privity, the only recourse left for aggrieved third parties was litigation for fraud.⁶²⁴ But fraud on the other hand was difficult to prove because normally, higher degree of proof is required. Since there is no such thing as an accidental or negligent fraud in law, plaintiffs in a fraud claim are required to show evidence of intent to deceive on the part of the auditor.⁶²⁵ Thus, the plaintiff has to establish that the auditor actually knew the audit was in error and did not believe in its contents when submitting the audit report. This requirement was elucidated by Judge SWAN in the case of *O'Connor v. Ludlam*,⁶²⁶ below:

Fraud may be established by showing a false representation has been made either knowingly, or without belief in its truth, or in reckless disregard of whether it be true or false... If they did have that honest belief, whether reasonably or unreasonably, they are not liable. If they did not have an honest belief in the truth, of their statements, they are liable... Further, if the audit made was so superficial as to be only a pretended audit and not a real audit, then the element of knowledge of falsity of their representation is present, and they may be held liable.⁶²⁷

⁶²² SEPTIMUS, J., Accountants' Liability..., op. cit., p. 408.

⁶²³ BAKER, C. R. & PRENTICE, D., "The Origins of Auditor Liability to Third Parties under United States Common Law", *Accounting History*, 13, 2008, p. 164. See also DAVIES, J.J., "Accountants' Third Party Liability: A History of Applied Sociological Jurisprudence", *Abacus*, 14, 1979.

⁶²⁴ Fraudulent representation by auditors is generally actionable without the necessity of privity.

⁶²⁵ BAKER, C. R. & PRENTICE, D., *Origins of Auditor Liability...*, op cit, p. 168, this requirement can also be met by establishing that the audit report was recklessly made with utmost disregard for truth or falsity.

⁶²⁶ 92 F.2d 50 (2d Cir. 1937)

⁶²⁷ Id at p. 54. Intention to deceive is referred to scienter in the American legal parlance. "Scienter", on the other hand, has been judicially defined as the "mental state embracing intent to deceive, manipulate, or defraud." See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) at p. 194

Because of the greater evidentiary burden they encounter in claims brought under fraud, third party plaintiffs are drawn more to tort of negligence as a more viable medium to recover their losses. But the courts continue to cling to the mindset that negligence per se cannot ground an action for recovery of damages. As reiterated by the Pennsylvania Supreme Court in the case of *Landell v. Lybrand*.⁶²⁸ The case is concerned with a suit brought against a certified public accounting firm by a third party that had relied on financial statements they certified. The plaintiff alleged that the financial statements were misleading and that he relied on them when making his investment. He also charged that the auditors were negligent in the performance of their duties and consequently liable for the loss he sustained. The court found for the accountants, stating the following:

There was no contractual relationship between the plaintiff and defendants, and if there is any liability from them to him, it must arise out of some breach of duty, for there is no averment that they made the report with intent to deceive him. The averment in the statement of claim is that the defendants were careless and negligent in making their report, but the plaintiff was a stranger to them and to it, and, as no duty rested upon them to him, they cannot be guilty of any negligence of which he can complain.⁶²⁹

Accordingly, the court drew a line of difference between intent to deceive, a necessary ingredient to sustain an action for fraud,⁶³⁰ and a breach of duty which arises out of contract.⁶³¹ The court further reasoned that for the plaintiff to prevail he must show a relationship of privity with the auditor, such that there is duty imposed by law on the auditor to act with care towards him. In the absence of such a duty and without proof of fraud, the court concluded that mere negligence does not suffice, even if damage is suffered by the plaintiff.⁶³²

⁶²⁸ (1919) 264 PA 406

⁶²⁹ Id.

⁶³⁰ See the dictum of Judge SWAN in the case of *O'Connor v. Ludlam* supra.

⁶³¹ Ordinary negligence means a lack of reasonable care in the performance of accounting duties. Reasonable implies using the knowledge, skill, and judgment usually possessed by practitioners in similar practice circumstances (Gavin et al, 1987).

⁶³² BAKER, C. R. & PRENTICE, D., *Origins of Auditor Liability...*, op cit, p. 169.

With time, the courts began to question the rationale behind the privity doctrine. In fact the courts have consistently sidestepped it in the area of negligent acts resulting into physical injury. One such instance was the *locus classicus* of *Heaven v. Pender*.⁶³³ In that case, the plaintiff, a painter employed by a painting contractor was injured when a staging erected by a dock owner collapsed. In an action for damages by the painter, the dock owner cited the principle of *Winterbottom v Wright*⁶³⁴ and contended that he owed no duty of care to the painter because his contract was with the ship owner not the painter. The Court of Appeal, in reversing the Divisional Court and allowing the appeal, observed in a renowned passage by BRETT, M.R. as follows:

Whenever one person is by circumstances placed in such a position with regard to another that everyone of ordinary sense who did think would at once recognize that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of the other, a duty arises to use ordinary care and skill to avoid such danger.⁶³⁵

In the United States the first assault on the “citadel of privity” could be traced back to the case of *Savings Bank v. Ward*.⁶³⁶ Although, the ratio *decidendi* of the case was notorious for importing the privity rule into the U.S., in the same judgment, the U.S. Supreme Court made exceptions to privity in “imminently dangerous” acts and in cases involving articles that were inherently dangerous and likely to “put human life in imminent danger.”⁶³⁷ This reasoning was put to practice by the Supreme Court of Wisconsin in the case of *Smith v. Atco Co.*⁶³⁸ where the court observed:

We deem that the time has come for this court to flatly declare that in a tort action for negligence against a manufacturer, or supplier, whether or not privity exists is wholly immaterial. The question of liability should be approached from the standpoint of the standard of care to be exercised by the reasonably prudent person in the shoes of the defendant manufacturer or supplier. Such an approach

⁶³³ 1883) 11 QBD 503

⁶³⁴ (1842) 152 ER 402

⁶³⁵ (1883) 11 QBD 503 at p. 509.

⁶³⁶ 100 U.S. 195 (1879)

⁶³⁷ *Id.*

⁶³⁸ (1959) 6 Wis. 2d 371

will eliminate any necessity of determining whether a particular product is “inherently dangerous.”⁶³⁹

But it was the insightful judgment of Judge CARDOZO in *Macpherson v. Buick Motors Co.*⁶⁴⁰ that finally opened the courthouse doors to persons claiming negligent injury as a separate cause of action. Although liability for negligence that results in physical injury to person or property soon became a settled law in the United States, the courts have been reluctant to extend this liability to cases of pure economic loss.

1.3 LIABILITY TO THIRD PARTIES IN THE UNITED STATES

1.3.1 AN HISTORICAL PERSPECTIVE: THE SHIFT AWAY FROM PRIVITY

The history of accountant liability in the United States is characterized by two important periods. The first period, which coincided with the build up to the industrial revolution and extended through the 1950s, liability restriction by courts made it almost impossible for third parties to recover their loss for negligently performed audit. This is not surprising because liability restrictive rule was adopted as a general policy. At the onset of the industrial revolution, the general concern was that “infant” businesses and manufacturers should not be overburdened with liability.⁶⁴¹ To protect these businesses and manufacturers, privity was devised by the courts to limit their liability to those who contracted them. The courts as a matter of policy, favored industrial growth, and the possibility that manufacturers might be forced into bankruptcy outweighed any moral concern to compensate every injured consumer.⁶⁴² As Friedman argues, “if railroads and enterprises generally had to pay for all damage done ‘by accident,’ lawsuits could drain them of their economic blood.”⁶⁴³ Consequently, the attitude taken by the courts generally, was that of no interference with the industrialization process, and where possible “to limit damages to some moderate measure.”⁶⁴⁴

⁶³⁹ Id. at p. 383.

⁶⁴⁰ (1916) 217 NY 382

⁶⁴¹ SEPTIMUS, J., Accountants’ Liability..., op. cit., p. 412.

⁶⁴² Id.

⁶⁴³ FRIEDMAN, L. M. (2002a) in BAKER, C. R. & PRENTICE, D., Origins of Auditor Liability..., op cit, p. 167.

⁶⁴⁴ Id.

The second period of auditor liability history began in the 1950s, when the industrial growth had already taken hold. With the consolidation of the industrial revolution, the policy of protecting manufacturers against litigation also diminished.⁶⁴⁵ As the twentieth century manufacturing got more sophisticated, consumer safety emerged as a factor of consideration in the design of a product.⁶⁴⁶ Accordingly, policy consideration in law that defines court's stance on liability shifted to the protection of consumers whose lives were affected by the huge industrial complex.⁶⁴⁷ As SEPTIMUS points out, "the desire to provide this protection was so great that the new form of liability for unsafe products was a liability without fault, imposed in the form of a warranty implied by law in the sale of goods."⁶⁴⁸ In the same sense, BAKER & PRENTICE argue that "changes in legal liability through time have often occurred in response to social and economic conflicts"⁶⁴⁹ affecting societies:

As William L. Prosser, in his classic tort treatise, observed, "perhaps more than any other branch of the law, the law of torts is a battleground of social theory." Although torts are sometimes perceived as a system of immutable rules, tort remedies are inevitably contested and contestable socio-legal terrain. Our review of the historical waxing and waning of rights and remedies demonstrates that torts have never been and can never be value-neutral. As Mannheim reminded us, all law reflects social and economic interests.⁶⁵⁰

Moreover, the dynamics of the twentieth century was far different from what then informed the privity doctrine. As ANDERSON argues,⁶⁵¹ it was inevitable that this rule of law, formulated before the industrial revolution, should become subject to exceptions

⁶⁴⁵ SEPTIMUS, J., *Accountants' Liability...*, op. cit., p. 412.

⁶⁴⁶ Id.

⁶⁴⁷ Id.

⁶⁴⁸ Id. These legislations that had begun as some form of warranty clauses were widely embraced almost across the board by all countries. In case of the U.S. it was incorporated into the U.S. Uniform Commercial Code in three variations. **U.C.C. ss. 2-318**. Now it had grown beyond national boundaries to regional level, as seen in the European Union Directive 2005/29/EC, which proposed a level playing field of consumer protection across the European Community. A goal it aims to achieve through the transposition of these set of rules unto national legislations. This soft law has now been adopted in the "Real Decreto Legislativo 1/2007" in Spain. In the United States on the hand, the current administration has new consumer protection agency called Bureau of Consumer Protection.

⁶⁴⁹ BAKER, C. R. & PRENTICE, D., *Origins of Auditor Liability...*, op cit. p. 166 with a quote from RUSTAD, M. L. & KOENIG, T. H., 2002, p. 8).

⁶⁵⁰ Id.

⁶⁵¹ ANDERSON, A. P., "Accountant Liability to Third Parties for an Audit", *Marquette Law Review*, 52, 1968, p. 161.

and limitations as the twentieth century was ushered in. Hence, the courts, faced with the necessity to extend the scope of tort law to the needs of the time, did not defraud. They rightly responded by expanding the reach of tort law to embrace new classes of plaintiffs as well as new categories of actions.⁶⁵² This revolutionary expansion of liability for negligence under common law is best understood by examining the instrumental reasoning used by courts as a tool for social engineering, as noted by SILICIANO:⁶⁵³

In justifying the expansion of liability rules, courts seldom rely primarily on the need to correct some perceived injustice visited on an individual plaintiff by the alleged tortfeasor. Reform instead is frequently defended as a means of furthering broader policy goals, such as creating incentives to encourage risk creators to take optimal levels of care or allocating the costs of accidents to parties better able to shoulder such losses.⁶⁵⁴

In *MacPherson v. Buick Motor Co.*⁶⁵⁵ for example, where the buyer of a car with a defective wheel brought an action in negligence against the car manufacturer, even though the wheel was actually built by another party who had a contract with the manufacturer. CARDOZO J. went against the then established legal precedents and enlarged the scope of recovery for negligence to the next level by holding the manufacturer liable. Prior to this case, exception to privity is admitted only when products involved are “inherently dangerous” but Judge Cardozo broadened the exception to privity to include products that are dangerous if negligently made. In allowing recovery for the plaintiff, the learned Judge held that a car when negligently built was dangerous to the ultimate user. Cardozo’s insightful dictum is produced below:

If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of danger. If to the element of danger there is added the knowledge that the thing will be used by persons other

⁶⁵² DOBBS, D. B., *The Law...*, op. cit., p. 168.

⁶⁵³ SILICIANO, J. A., “Negligent Accounting and the Limits of Instrumental Tort Reform”, *Michigan Law Review*, 86, 1988, p. 1929.

⁶⁵⁴ Id.

⁶⁵⁵ (1916) 217 NY 382, legal precedents had previously prevented consumers from recovery of damages unless they bought directly from the manufacturer.

than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.⁶⁵⁶

Six year later, the same CARDOZO J. imposed liability for economic loss in the first case involving the recovery of damage for financial loss, *Glanzer v. Shepard*.⁶⁵⁷ In this case, the seller of beans contracted a weigher to certify the weight of the beans. The weigher's certificate, which forms the basis of the contract between buyer and seller, was overstated. The buyer instituted this action asserting negligence on the part of the weigher. Even though the court recognized that the plaintiff was not a party to the contract, it reasoned that the plaintiff was the primary beneficiary of the contract hence the weigher owed a duty of care to him. CARDOZO J. went on to elucidate the concept of 'primary benefit' as follows:

[T]he plaintiff's use of the certificates was not an indirect or collateral consequence of the action of the weighers.... It was... the end and aim of the transaction.... The defendants held themselves out to the public as skilled and careful in their calling.... In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed.⁶⁵⁸

Under this analysis, although there was no contract between the weigher and the buyer because the "end and aim" of the transaction was to provide a service to the buyer, the weigher was held liable. The fact that the contract was not between the plaintiff-buyer and the defendant-weigher was of no consequence, if the relationship between the plaintiff and the contracting parties is as close as in this case. The buyer, therefore, can maintain an action against the weigher either for negligent performance of service or as a third party beneficiary of the weigher's contract with the seller. Here, recovery is premised on the relationship between the plaintiff and the parties in contract, a clear triumph of practical substance over legal form: "equity looks to the substance rather than to the form", as the maxim goes.

⁶⁵⁶ Id.

⁶⁵⁷ (N.Y. 1922) 135 N.E. 275

⁶⁵⁸ Id. at p. 275-276.

1.3.2 THE RETURN OF PRIVACY

The departure from the restrictive notion of privity marked by these cases and the new era of liability-expanding theory of negligence they heralded met with a brick wall in the case of *Ultramares Corp. v. Touch, Niven & Co.*⁶⁵⁹ where privity was re-established. Judge CARDOZO declined the opportunity presented by this case to expand tort liability for economic loss. He refused to extend the foreseeability principle of *MacPherson* to economic loss caused by an auditor's neglect, and he also limited *Glanzer's* 'end and aim' concept to cases in which there was a connection between the plaintiff and the defendant that was the "equivalent of privity".⁶⁶⁰

In this case, the creditor of Fred Stern & Co. brought an action against the accounting firm, Touch, Niven & Co. that audited the accounts of its then bankrupt-debtor. The creditor claimed it suffered a loss due to reliance on erroneous information in the financial statement of the debtor, audited by the defendants. The plaintiff citing numerous discrepancies in the audit report argued that the defendants had been negligent and fraudulent in performing the audit.

The Court of Appeal found that the accountants were only guilty of negligence, but because of the lack of a specific contract between the plaintiff and the defendant there was no duty of care owed by the defendant to the plaintiff. Therefore no liability ensued on the accountants' part. In his judgment Judge CARDOZO referred to *Glanzer* and distinguished it from *Ultramares*. He reasoned that in *Glanzer* the plaintiff was not one out of many who may be recipients of the certificate but was the purpose of the contract from the first place. In fact, the only foreseen user was the plaintiff, whereas in *Ultramares* the plaintiff was one of many foreseeable users. Judge CARDOZO went on to

⁶⁵⁹ (1931) 255 NY 170

⁶⁶⁰ *Id.* at 446. The court went on to consider *Glanzer v. Shepard* and distinguish it from *Ultramares* as follows:

[in *Glanzer*, there] was something more than the rendition of a service in expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the "end and aim of the transaction" In a word, the service rendered by the defendant in *Glanzer v. Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. Foresight of these possibilities may change with liability for fraud. The conclusion does not follow that it will change with liability for negligence. *Id.* at p. 176.

hold that an accountant could only be liable to the person who hired him. Meanwhile, in terms of privity, it is pertinent to point out that CARDOZO did not restrict accountant liability along traditional privity of contract lines or foreclosed recovery for those specific persons the auditor knew were recipients who would rely on the information. However, if the auditor's actions constituted fraudulent misrepresentation liability will ensue. The court went on to discuss how the act of fraud might be inferred from a negligent act:

Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It does no more than say that if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average business man receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more...⁶⁶¹

CARDOZO J. thought that allowing third parties to recover would place an undue burden on the auditor and concluded that:

To creditors and investors to whom [Stern] exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a

⁶⁶¹ Id. at p. 188.

flaw may not exist in the implication of a duty that exposes to these consequences.⁶⁶²

The policies stated in *Ultramares* set the standard for accountant liability for the next third of a century. The doctrine set forth in *Ultramares* supports the finding that accountants are not liable to an indeterminate class of individuals who may rely upon the accountant's negligent audit even if they suffer loss.⁶⁶³ Through the years, *Ultramares* has been cited in innumerable cases as the landmark decision protecting auditors from third party suits.⁶⁶⁴

Yet, as seen above, outside the accounting arena, the merits of liability limitations based on privity had been increasingly attacked, particularly, in the area of products liability where the notion of privity has been a clog in the wheels of justice. The argument that recovery should be denied to an injured or killed third party because he is not in contract with the defendant no longer resonate with the courts. As a result, a number of states, like New Jersey and Wisconsin had abandoned contract-based theory in favor of a negligence regime. These states measure the scope of manufacturer's duty to extend to all those who might foreseeably be injured by its product.

As a result of these changes, the foreseeability of harm, rather than the nature of the contract, began to define legal duty in many areas of the law across the United States.⁶⁶⁵ Nonetheless, as common law is a matter of state law, jurisdictions vary on the scope of negligence liability for accountants.

⁶⁶² Id. at p. 180

⁶⁶³ GREENE, D. F., ALFONSE R., PETROCINE, R. A. & FITZPATRICK, C. R., "Holding Accountants Accountable: The Liability of Accountants to Third Parties", *Employee Responsibilities and Rights Journal*, 15, 2003, p. 25.

⁶⁶⁴ DALY, B. A. & GIBSON, J. M., "The Delineation of Accountants' Legal Liability to Third Parties: Bily and Beyond", *St. John's Law Review*, 68, 1994, 620.

⁶⁶⁵ SILICIANO, J. A., Trends in Independent..., op. cit., p. 344.

2. THE CONSTANT QUEST FOR ADEQUATE STANDARD OF CARE

2.1 THE DIFFERENT APPROACHES

The cases that have interpreted the common law regarding auditor's duty of care to third parties have varied from state to state within the United States.⁶⁶⁶ A split exists among the States as to the individuals to whom the auditor owes a duty of care. There are different doctrinal views on third party liability: the privity or Ultramares rule, the near privity rule, the foreseeability standard, and the Restatement approach. Therefore, because of the differences in these approaches, and depending on which view is adopted in a particular state, an auditor may be subject to suit in State A but not in State B under the same set of facts.⁶⁶⁷ This section examines these differences.

2.2 THE PRIVACY STANDARD

This time-honored concept in tort law was first applied in the United States through the medium of the Supreme Court case of *Savings Bank v. Ward*.⁶⁶⁸ In this case, a bank which lent money for the purchase of a real estate in reliance on an erroneous title report sued the lawyer who prepared the report. The court cited *Winterbottom* with approval and held that if allowed, third party actions could lead to 'absurd consequences' and push this remedy to an impracticable extreme. Accordingly, *Savings Bank v. Ward* quickly established that there cannot be recovery for economic loss in the absence of privity.⁶⁶⁹ Some sixteen years later the Supreme Court of California asserted that the "overwhelming weight of authority" supported the doctrine. The Pennsylvania Supreme Court, in the early accountant liability case of *Lybrand*, applied the same rule developed in *Savings Bank* to bar an action by the purchaser of stock in a company against the accountant that had prepared its financial statements.

The line of authorities after *Ultramares* hold audit sacred within the boundaries of contract. Third parties standing outside the agreement might gratuitously benefit from the audit report but they generally have no recourse against the public accountant if they

⁶⁶⁶ PACINI, C., MARTIN, M. J., & HAMILTON, L., "At the Interface of Law and Accounting: An Examination of a Trend toward a Reduction in the Scope of Auditor Liability to Third Parties in Common Law Countries", *American Business Law Journal*, 37, 2000, p. 171.

⁶⁶⁷ Id.

⁶⁶⁸ (1979) 100 US 195

⁶⁶⁹ FEINMAN, J. M., "Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology", *Florida State University Law Review*, 31, 2003, p. 23.

suffer any harm as a result. One notable authority here was *State Street Trust Co. v. Ernst*,⁶⁷⁰ where the court noted:

We have held that in the absence of a contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit ... Accountants, however, may be liable to third parties, even where there is lacking, deliberate or active fraud ... [H]eedless and reckless disregard of consequence may take the place of deliberate intention.⁶⁷¹

Under this analysis, third parties might have relied and acted upon the auditor's opinion, nonetheless they are not third party beneficiaries, but incidental beneficiaries of the contractual relationship between accountant and his client. Hence, they can neither enforce the contract nor complain, in the legal sense, if the accountant's negligent performance under the contract causes financial loss to them. This rule became known as strict privity doctrine because it does not admit of any duty beyond the realm of contract.

Although in *Ultramares*, the New York Court of Appeals reaffirmed privity as a prerequisite of liability for the negligent performance of an audit. The *Ultramares* court's interpretation of *Glanzer* effectively established a rule that only if the third party could enforce the defendant's contract as a third-party beneficiary would he be able to bring the action in negligence. This rule provided an excellent example for future expansion of third party liability.

In a series of cases, the New York Court of Appeals has explained and modified the *Ultramares* doctrine in ways that have been influential in other jurisdictions. This development came to be referred to as near privity standard. Under this approach an auditor is imputed with a duty of care to those parties with whom he has an acknowledged relationship. For example in the case of *Credit Alliance Corp. v. Andersen & Co.*,⁶⁷² the court again rejected a wider duty for the auditor. The court while

⁶⁷⁰ 278 N.Y. 104, (1938)

⁶⁷¹ Id at p. 111.

⁶⁷² 483 N.E. 2d at pp. 111-12, 119-20

reaffirming its commitment Judge CARDOZO's concerns in *Ultramares*, revised *Ultramares* and outlined the following test as a prerequisite for holding accountants liable to third parties user of financial information not directly in privity:

Before accountants may be held liable in negligence to non contractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in furtherance of which the known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces that accountants' understanding of that party or parties' reliance.⁶⁷³

This requirement defines a relationship sufficiently narrow for the accountant to avoid indeterminate liability and predict the scope of its exposure to liability. At the same time, the test aims to provide criteria that are easier to apply than the more general formulations prescribed in *Ultramares* and *Glanzer*, nonetheless, they "do not represent a departure from the principles articulated in *Ultramares* [and] *Glanzer* ... but, rather, they are intended to preserve the wisdom and policy set forth therein."⁶⁷⁴

In a practical illustration of the application of this rule, in *Credit Alliance*, an accountant was found not liable to a non-privity plaintiff that had loaned money to the accountant's client in reliance on the accountant's erroneous audit, a report of which had been provided to it by the client. And despite a constructive knowledge of the defendants that the report has been shown to the plaintiff to induce a loan. The court found no evidence of any word or action that link the plaintiffs to the defendants. The court in reaching this decision analyzed the facts in issue in the light of the applicable state law and opined that:⁶⁷⁵

[T]here is no allegation that [the accounting firm] had any direct dealings with the [creditor], had specifically agreed with [the debtor] to prepare the report for the [creditor's] use or according to the [creditor's] requirements, or had

⁶⁷³ Id.

⁶⁷⁴ *Credit Alliance Corp. v. Andersen & Co.*, at p. 118. See also FEINMAN, J. M., Liability of Accountants..., op. cit., p. 35.

⁶⁷⁵ Id., arguably, all three elements required were lacking.

specifically agreed with [the debtor] to provide [the creditor] with a copy or actually did so. Indeed there is simply no allegation of any word or action on the part of [the accounting firm] directed to [the creditor], of anything contained in [the accounting firm's] agreement with the [debtor] which provided the necessary link between [the accounting firm and the creditor].⁶⁷⁶

The principle enunciated in *Ultramares* continues to evolve by accommodating some measure of flexibility as seen in *White v. Guarantee*.⁶⁷⁷ The case concerned an end of year audit by the defendant on Guarantee-Harrington Associates, a hedge fund investing and trading in marketable securities. White, a limited partner, commenced an action against the audit firm alleging, among others, negligence by the auditor to disclose the improper withdrawal of \$2,000,000 by the two general partners.

The defendants relying on *Ultramares* successfully applied for summary dismissal in the lower court. But the Court of Appeals reversed the order, holding that accountants may be held liable in negligence to third parties when the potential group of plaintiffs could be defined. The court reasoned that services of the accountant are not extended to a faceless or unresolved class of persons, but to a known group possessed of vested rights, in this case actual limited partners fixed and determined. Therefore it is foreseeable to the defendants that as one of the limited partners, the plaintiff would rely on the audit to prepare its own tax returns. Although White did not overrule *Ultramares*, it certainly detracts from the sense of invincibility formerly attached to *Ultramares* and signaled a new trend for the future.

The privity doctrine as articulated in *Ultramares* and extended in *Credit Alliance* still commands good following in the United States. It is applied by some federal courts,⁶⁷⁸ and among the at least, nine states that adopted it, four had promulgated it into law.⁶⁷⁹

⁶⁷⁶ *Credit Alliance Corp. v. Andersen & Co.*, at p. 19.

⁶⁷⁷ N.Y. 2nd 356 (1977)

⁶⁷⁸ VICK, S., *Bily v. Arthur Young*..., op. cit., p. 1348.

⁶⁷⁹ *Id* at p. 1347.

2.3 THE REASONABLE FORESEEABILITY STANDARD

For several decades, faithfulness to the privity or near privity doctrine has kept tort law at bay by maintaining accountant liability within the spheres of the law of contract, admitting recovery only where there is privity or a third-party beneficiary relationship,⁶⁸⁰ and in some cases where there is ‘conduct linking’ element.⁶⁸¹ However, by the mid 1900 the same forces of progress which forced a retreat from *Winterbottom v. Wright* began to question the wisdom of the *Ultramares*’ position.⁶⁸² According to FEINMAN, the series of challenge these forces mounted resulted in many jurisdictions moving away from the privity rule in significant respect.⁶⁸³ One of such cases where similar sentiment was reechoed was *Carter v. Yardly & Co.*⁶⁸⁴ as reproduced below:

The time has come for us to recognize that asserted general rule no longer exists. In principle it was unsound. It tended to produce unjust results. It has been abandoned by the great weight of authority elsewhere. We now abandon it in this commonwealth.⁶⁸⁵

The courts then went on to treat these cases the same as ordinary negligence cases and apply a rule of liability for foreseeable harm, as was the case with defective product. They used this standard to extend an auditor’s liability to all those whom the auditor should reasonably foresee as receiving and relying on the audited statement. Liability no longer depends on the accountant’s knowledge of either the users or the intended class of users of his or her work/product.⁶⁸⁶

⁶⁸⁰ FENCL, E. R., “Rebuilding the Citadel: State Legislative Responses to Accountant Non-Privity Suits”, *Wash. U. L. Q.* 67, 1989, p. 866.

⁶⁸¹ FEINMAN, J. M., *Liability of Accountants...*, op. cit., p. 16.

⁶⁸² Anderson, A. P., op. cit., p. 161. The first important challenge to the wisdom behind the *Ultramares* doctrine came on the other side of the Atlantic by way of dissent opinion by Lord Denning in *Candler v. Crane, Christmas & Co.*, 2 K.B. 164 (1951). Denning argued that by insulating accountants from liability through privity the court is disregarding the realities of the audit function, which is meant to evince reliance from investors:

[Accountants make reports on which other people . . . other than their clients ... rely in the ordinary course of business . . . [They are] in my opinion, in proper cases, apart from any contract in the matter, under a duty to use reasonable care in preparation of their accounts and in the making of their reports. Id.

⁶⁸³ FEINMAN, J. M., *Liability of Accountants...*, op. cit., p. 16.

⁶⁸⁴ (1946), 64 N.E. 2d 693

⁶⁸⁵ Id. at p. 700.

⁶⁸⁶ GREENE, D. F., ET AL., *Holding Accountants Accountable...*, op. cit., p. 27.

The most celebrated case on foreseeability in accountant liability is the New Jersey Supreme Court case of *Rosenblum, Inc. v. Adler*.⁶⁸⁷ The facts of the case mirrored *Ultramares*. A public accountant again had negligently failed to uncover serious errors in the financial statement of another ailing company, this time Giant Stores Corporation. In the wake of the company's bankruptcy, the third party plaintiff sued the accounting firm for losses suffered as a result of reliance on the firm's audit.

The firm defended on privity grounds that the plaintiffs were strangers to the contract between the accounting firm and the audited company, but the plaintiffs countered with the analogical argument of audit-as-product. This time the court took the bait, affirming the plaintiffs' grounds. The court argued that since injury resulting from negligent misrepresentation in product defects is generally actionable without regard to privity, there is no basis on which to bar a claim of ordinary negligence for a similar lack of privity. The court turned its discussion on fairness of this proposition, and noted that:

[T]here remains to be considered whether the public interest will be served by a proposition holding an auditor responsible for negligence to those persons who the auditor should reasonably foresee will be given the audit to rely upon and do in fact place such reliance to their detriment. Should there be such a duty?⁶⁸⁸

The court then went on to analyze the basic principle of tort law: the historical movement away from privity in cases of physical injuries to defective products as well as economic loss cases, and held that:

Unless some policy considerations warrant otherwise, privity should not be, and is not, a salutary predicate to prevent recovery. Generally, within the outer limits fixed by the court as a matter of law, the reasonably foreseeable consequences of the negligent act define the duty and should be actionable.⁶⁸⁹

The court looked farther to securities statutes and reasoned that the accountant is "a kind of arbiter" among the competing interests of his client, third parties who may rely on his

⁶⁸⁷ (1983), 93 N.J. 324

⁶⁸⁸ Id at p. 333.

⁶⁸⁹ Id at p. 331.

work, and of course his own professional responsibility.⁶⁹⁰ The court continued further that it is untenable to bar economic loss recovery in negligent misrepresentation cases when same is allowed in product defects cases. The court in dispelling any liability concern, concluded that contrary to the view expressed in *Ultramares*,⁶⁹¹ imposition of liability through negligent misrepresentation will not have deleterious consequences but rather it will provide an incentive for accountants to exercise due care.⁶⁹² The court then went on to weigh the risk involved in this decision against the public interest it would serve, and stated:

[T]he burden [that the suggested duty] would put on defendant's activity; the extent to which the risk is one normally incident to that activity; the risk and the burden to [the] plaintiff; the respective availability and cost of insurance to the two parties; the prevalence of insurance in fact; the desirability and effectiveness of putting the pressure to insure on one rather than the other, and the like.⁶⁹³

Thus, the accounting firms who bore such liabilities could easily avoid financial ruin through insurance, the cost of which would be passed onto the client and ultimately to the client's consumers.⁶⁹⁴ The court went on and formulated a liability rule based on foreseeability of harm as follows:

When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes.⁶⁹⁵

The New Jersey Supreme Court found on behalf of the plaintiff that use of financial statements for purposes such as securities offering and corporate acquisitions were foreseen or foreseeable by the defendants, therefore liable. Moreover, defendants were aware of the merger negotiations, but the court found that liability does not depend on

⁶⁹⁰ Id. at p. 336.

⁶⁹¹ 174 N.E. 441 (N.Y. 1931)

⁶⁹² *Rosenblum*, 93 N. J. at p. 349.

⁶⁹³ Id.

⁶⁹⁴ Id. at p. 338, see also SILICIANO, J. A., Trends in Independent..., op. cit., p. 345

⁶⁹⁵ Id. at p. 352.

the accountant's knowledge of either the users or the intended class of users of the report. All that was necessary for imposition of liability was that the client, Giant Stores Corporation, used the report for a proper business purpose in the course of which a third party justifiably and foreseeably relied on the report.⁶⁹⁶ The court then concluded that making auditors liable to all foreseeable users was the way to go if users of financial statements were to be protected and auditors held accountable for the quality of their work/product:

Certified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. In those circumstances, accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day.⁶⁹⁷

The Supreme Court of Wisconsin followed *Rosenblum* on quick succession with its decision in *Citizens State Bank v Timm, Schmidt & Co.*⁶⁹⁸ The court here argued, in favor of full resolution of these kinds of cases on the merit instead of dismissal or summary judgment. It was of a considered opinion of the court that accountant liability cases ought to be determined in accordance with the general principles of negligence law, where “a tortfeasor is fully liable for all foreseeable consequences of his act except as those consequences are limited by policy factors.”⁶⁹⁹ The court recognized that some public policy factors might justify limiting the accountant's duty. These justifications are that:

(1) [t]he injury is too remote from the negligence; or (2) the injury is too wholly out of proportion to the culpability of the [defendant]; or (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or (4) because allowance of recovery would place too unreasonable a burden on the [defendant]; or (5) because allowance of recovery would be too

⁶⁹⁶ *Rosenblum*, 93 N. J. at p. 331. Also FEINMAN, J. M., *Liability of Accountants...*, op. cit., p. 40.

⁶⁹⁷ *Id* at pp. 350-351.

⁶⁹⁸ 335 N.W. 2d 361 (Wis. 1983)

⁶⁹⁹ *Id*.

likely to open the way for fraudulent claims; or (6) allowance of recovery would enter a field that has no sensible or just stopping point.⁷⁰⁰

The foreseeability rule had earlier enjoyed wide acceptance and found support among some commentators, who argued that it serves important policy objectives such as deterrence and cost spreading.⁷⁰¹ Despite this fact, currently only a handful of states like New Jersey, Wisconsin and Mississippi base recovery for negligence solely on this rule.⁷⁰²

2.4 THE RESTATEMENT STANDARD

Another way of considering auditor's duty of care to third parties under common law is known as the Restatement of Torts approach. A notion of liability to third parties proposed and incorporated into the *Restatement (Second) of Torts*, section 552 as a standard for accountant liability. Section 552 is adopted by the courts as an alternative to the rigid requirement of the *Ultramares* standard and its progeny.⁷⁰³ The pertinent part of section 552 provides:

Information Negligently Supplied for the Guidance of Others

- (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
- (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

⁷⁰⁰ Id at p. 366.

⁷⁰¹ VICK, S., *Bily v. Arthur Young*..., op. cit., p. 1349.

⁷⁰² Id at p. 1348.

⁷⁰³ ZISA, J. W., "Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information", *Campbell L. Rev.* 11, 1989, p. 139.

- (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
- (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Under this section, liability for negligent misrepresentation is imposed on one whom in the course of his business, supplies false information for the guidance of others who justifiably relied upon this information and as a result suffered a pecuniary loss. These persons need not to be known to the auditor so long as they belong to a class that the audit was intended to benefit for a particular transaction known to the auditor. Consequently, an accountant who audits financial information for a client would be liable to third parties “provided they belong to a ‘limited group’ and provided that the accountant had knowledge that his professional opinion would be supplied to the limited group.”⁷⁰⁴

By application of the provision of section 522, an auditor needs not know the specific identity of the lender, to be liable to a third party lender. It would be sufficient if he was informed by his client that the purpose of the audit is to help obtain a loan. As held, for example, in *Rusch Factors, Inc. v. Levin*,⁷⁰⁵ the first case to apply the Restatement standard. The facts of *Rusch Factors* are as follows, a corporation applied for financing from the plaintiff. The plaintiff requested audited financial statements of the debtor to measure the debtor’s financial position. The debtor then engaged the defendant accounting firm whose audited financial statements “represented the [debtor] to be solvent by a substantial amount. In fact, the corporation was insolvent.”⁷⁰⁶ The court held that although the auditors did not know the plaintiffs they were aware that the audit was meant to help obtain a loan. Hence, they were held liable.

⁷⁰⁴ SHROYER, J. T., “Accountants and the Dynamics of Duty”, *Wm Mitchell Law Review*, 1988, p. 96.

⁷⁰⁵ 284 F. Supp. 85 (D. R. I. 1968)

⁷⁰⁶ *Id* at p. 86.

In its evaluation of the *Rusch* case, the court adopted the end and aim analysis of *Glanzer* with transaction in *Rusch*, but “distinguished *Ultramares* by defining this particular plaintiff as a party whose reliance was actually foreseen by the defendant.”⁷⁰⁷

The court noted:

[In *Ultramares*] the plaintiff was member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable. Here the plaintiff is a single party whose reliance was actually foreseen by the defendant.⁷⁰⁸

The court then concluded that “[t]he defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential [creditors] of the ... corporation.”⁷⁰⁹ The court went on to question the wisdom of the *Ultramares* decision, as pronounced below:

[t]he wisdom on the decision in *Ultramares* has been doubted ... and this court shares the doubt. Why should an innocent reliable party be forced to carry the weighty burden of an accountant’s professional malpractice? Isn’t the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers who can in turn pass the cost onto the entire consuming public? Finally, wouldn’t a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this Court the decision in *Ultramares* constitutes an unwarranted inroad upon the principle that the risk reasonably to be perceived defines the duty to be obeyed.⁷¹⁰

But, why did the *Rusch* court in claiming to apply the Restatement standard retreat to the end and aim analysis in *Glanzer*? To this, ZISA argues that, “[t]o the extent that the auditor knew of the plaintiff-creditor at the time of his work and that this plaintiff’s use of the financial statements was contemplated by all parties to the audit contract, the plaintiff’s use was the end and aim of the audit engagement. While the *Rusch* court noted

⁷⁰⁷ Id at p. 87.

⁷⁰⁸ Id at p. 86.

⁷⁰⁹ Id at p. 93

⁷¹⁰ Id at p. 90.

that the *Glanzer* principle had been effectively adopted by the Restatement, the court would not so limit the scope of Restatement recovery. Instead, the *Rusch* court held that an “accountant should be liable in negligence for careless financial misrepresentations relied upon by an actually foreseen and limited class of persons.” That *Rusch* represented the first meaningful departure from privity motions is undeniable. The *Rusch* court clearly followed the *Glanzer* rule, identifying the Restatement (Second) approach as the *Glanzer* approach and applied it to accountants. However, such analysis ignores the clear distinction between the actual knowledge of an identified plaintiff required by *Glanzer* and the specifically foreseen person standard used in the Restatement (Second) approach. But as the auditor in *Rusch* knew that he was engaged to prepare audited financial statements to be used by his client, the *Rusch* result is justifiable by reference to either the *Glanzer* or the Restatement (Second) approach.”⁷¹¹

The *Rusch* case was closely followed by the case of *Ryan v Kanne*,⁷¹² a Supreme Court of Iowa decision also adopting the Restatement standard. In this case, the defendants were employed by a company to prepare a balance sheet for the purpose of obtaining a loan. The balance sheet they prepared showed that the company was solvent, when it was actually insolvent. The court, in embracing the restatement standard, held that the purpose of the defendants’ employment was enough to make them liable irrespective of the fact that they did not know the plaintiff.

In adopting this standard, the American Law Institute (ALI) took cognizance of the concern expressed by CARDOZO J. in *Ultramares* and reasoned that the foreseeable proposition, where virtually any third parties can sue the auditor could potentially ruin the profession.⁷¹³ This prospect, they argued would lead to a reduction in audit services, which would in turn restrict the flow of information “upon which the operation of the economy rests.”⁷¹⁴ Although the *Restatement of Torts* does not constitute US law, it has been adopted by the overwhelming majority of states. The Restatement rule is preferred by its adherents for prescribing a middle-ground between the restrictive privity approach and a possible unlimited liability facilitated by the foreseeability doctrine.

⁷¹¹ ZISA, J. W., “Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information”, *Campbell L. Rev.* 11, 1989, p. 141.

⁷¹² (Iowa 1969), 170 N.W. 2d 395

⁷¹³ Restatement (Second) of Torts section 522, Comment h.

⁷¹⁴ *Id.*

This much was affirmed by North Carolina Supreme Court in its celebrated opinion in *Raritan River Steel v Cherry*, etc.⁷¹⁵

[Section 552] recognizes that liability should extend not only to those with whom the accountant is in privity or near privity, but also to those persons, or classes of persons, whom he knows and intends will rely on his opinion, or whom he knows his client intends will so rely. On the other hand, as the commentary makes clear, it prevents extension of liability in situations where the accountant “merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated.” Restatement (Second) of Torts section 552, Comment h. As such it balances, more so than the other standards, the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking.⁷¹⁶

Notwithstanding above cases, the leading case articulating the application of section 552 is the case of *Bily v Arthur Young & Co.*,⁷¹⁷ where the California Supreme Court overturned the state’s prior adoption of the reasonable foreseeability rule in *International Mortgage Co. v John Butler Accountancy Corp.*⁷¹⁸ The *Bily* case arose from the failure of the Osborne Computer Corporation. In early 1983, certain plaintiffs provided direct loans to Osborne or standby letters of credit to secure bank loans. The loans were to have served as short-term financing until Osborne’s completion of an initial public offering. The public offering never occurred and Osborne filed for bankruptcy in 1983.

After a thorough analysis of the various legal standards applicable to accountants’ liability, the *Bily* court adopted the Restatement standard. *Bily* is significant because the court’s rejection of the foreseeable user doctrine represents a policy shift away from protecting the rights and expectations of investors, lenders, and the public in favor of a

⁷¹⁵ 367 S.E.2d 609 (N.C. 1988)

⁷¹⁶ Id. at p. 617.

⁷¹⁷ 834 P.2d 745 (Cal. 1992)

⁷¹⁸ 223 Cal. Rptr. 218 (Cal. Ct. App. 1986)

policy that shields accountants from liability to a large number of non clients.⁷¹⁹ The court reasoned as follows:

Given . . . the difficult and potentially tenuous causal relationships between audit reports and economic losses from investment and credit decisions, the auditor exposed to negligence claims from all foreseeable third parties faces potential liability far out of proportion to its fault; (2) the generally more sophisticated class of plaintiffs in auditor liability cases (e .g ., business lenders and investors) permits the effective use of contract rather than tort liability to control and adjust the relevant risks through "private ordering" ; and (3) the asserted advantages of more accurate auditing and more efficient loss spreading relied upon by those who advocate a pure foreseeability approach are unlikely to occur.⁷²⁰

The representation must have been made with the intent to induce plaintiff, or a particular class of persons to which plaintiff belongs, to act in reliance upon the representation in a specific transaction, or a specific type of transaction, that defendant intended to influence. Defendant is deemed to have intended to influence [its client's] transaction with plaintiff whenever defendant knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction. If others become aware of the representation and act upon it, there is no liability even though defendant should reasonably have foreseen such a possibility.⁷²¹

In the light of the decisions in *Rusch Factors* and *Ryan*, the application of the Restatement rule became reasonably clear when the auditor actually knows and intends that financial information be relied upon by a particular third party or limited group.⁷²² But, GRUBBS & ETHRIDGE JR. contends that, "courts have had to contend with how to interpret and how far to extend the intended beneficiary or "knows that the recipient intends to supply it..." provision."⁷²³ A comment to the Restatement reads in part follows:

⁷¹⁹ For more on this please see PANTTAJA, R. S., Accountants' Duty..., supra.

⁷²⁰ 834 P .2d 745 (Cal. 1992)

⁷²¹ Id.

⁷²² GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 84.

⁷²³ Id. See also FEINMAN, J. M., Liability of Accountants..., op. cit., p. 48.

...it is not required that the person who is to become the plaintiff be identified or known to the defendant as an individual when the information is supplied...it is enough that the maker of the representation intends it to reach and influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it.⁷²⁴

In *Carello v. PricewaterhouseCoopers, L.L.P.*,⁷²⁵ the plaintiffs made the decision to sell their company upon relying on an audit prepared by the defendants, which happened to be erroneous. The plaintiffs brought this action for the loss of their stock because of the bankruptcy declared by the purchasing company. Defendant had prepared the financial statements and audit reports for the buyer. Defendant filed a motion for summary judgment,⁷²⁶ contending that they were not aware at the time of the audit that it was being performed for the purpose of the sale or that the audit report would be used in connection with the sale.⁷²⁷

The audited financial statements that the plaintiff relied on were filed with the SEC on March 31, 1998, and March 31, 1999. There was evidence that the plaintiffs were not approached regarding the sale until July 1, 1999.⁷²⁸ Defendants argued that they could not have owed a duty to the plaintiffs under Restatement of Torts Section 552 because the section requires that “a defendant must have owed to the plaintiff the requisite discovery duty at the time the alleged misrepresentations were made”.⁷²⁹ However, material evidence was presented by the plaintiffs to the contrary regarding the defendant’s knowledge about the potential use of the statements. The plaintiffs contended that further discovery would reveal that the defendants were “actively assisting LASON (the prospective buyer) in gobbling up companies” prior to and during

⁷²⁴ Id (quoting Restatement (Second) of Torts section 552 (1977), comment h).

⁷²⁵ 2002 WL 1454111 (Del. Super. July 3, 2002)

⁷²⁶ This is a procedure used in civil litigations to expeditiously dispose of a case without a trial, especially, when the material facts are not in dispute between the parties. However, a judge may decide otherwise and put the case to trial.

⁷²⁷ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 84.

⁷²⁸ Id.

⁷²⁹ Id.

the relevant time period and therefore should have been aware that third party sellers would be relying on their work.⁷³⁰

The court denied the motion for summary judgment and found on behalf of the plaintiffs that, the words “should have known” is not requirement of actual knowledge but rather an expansive treatment of the restatement rule.⁷³¹

In a similar development, the Texas Fifth District Court of Appeals in *Blue Bell, Inc. v Peat, Marwick, Mitchell & Co.*⁷³² (1986) held that “actual knowledge of a particular plaintiff or class of plaintiffs is not necessary if the defendant should have had this knowledge through current business practices”.⁷³³ The court went on to argue that:

To allow liability to turn on the fortuitous occurrence that the accountant’s client specifically mentions a person or class of persons who are to receive the reports, when the accountant may have that same knowledge as a matter of business practice, is too tenuous a distinction for us to adopt as a rule of law. Instead, we hold that if, under current business practices and the circumstances of that case, an accountant preparing audited financial statements knows or should know that such statements will be relied upon by a limited class of persons, the accountant may be liable for injuries to members of that class relying on his certification of the audited reports.⁷³⁴

Expansive interpretation of the Restatement rule is the most favorable to plaintiffs and approaches one of foreseeability. However, there is other side of the argument that opted for restrictive application of the Restatement rule. For instance, in *Nycal Corp. v KPMG Peat Marwick LLP*⁷³⁵ the defendants were retained by a company to audit its financial statements. The audit report prepared by the defendants was included in the company’s annual report and made available to the public. The plaintiffs allegedly placed reliance on the audit in buying the controlling shares of the company. Two years

⁷³⁰ Id.

⁷³¹ Id.

⁷³² 715 S.W. 2d 408 (Tex. App. 1986)

⁷³³ *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.* 715 S.W.2d 408 (1986) at 411-13 and GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 85.

⁷³⁴ Id. at p. 412.

⁷³⁵ 688 N.E.2d 1368 (Mass. 1998)

after this transaction the company filed for bankruptcy and the shares bought by the plaintiffs became worthless. The plaintiffs instituted this action against the accounting firm for negligent misrepresentation. In a case of first impression⁷³⁶ in Massachusetts, the Supreme Court of Massachusetts declined to follow the broad construction in the *Blue Bell* case and opted for the “better reasoned” court decision interpretations “limiting the potential liability of an accountant to non contractual third parties who can demonstrate ‘actual knowledge on the part of accountants of the limited—though unnamed—group to potential [third parties] that will rely on the [report], as well as actual knowledge of the particular financial transaction that such information is designed to influence.’”⁷³⁷

The court held in summary judgment that the defendant owed no duty of care to the plaintiff. Since “the accountant’s knowledge is to be measured ‘at the moment the audit [report] is published, not by the foreseeable path of harm envisioned by [litigants] years following an unfortunate business decision.’”⁷³⁸

The same decision was reached in the case of *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*,⁷³⁹ where the court applied the Restatement rule for negligent misrepresentation against attorneys, and stated that, “a section 552 cause of action is available only when information is transferred by an attorney to a known party for a known purpose.”⁷⁴⁰ In another case, *Tara Capital Partners L.L.P. v. Deloitte & Touche, L.L.P.*,⁷⁴¹ the Court of Appeals of Texas in Dallas held that the plaintiffs in this case were not members of an identifiable limited group of which auditors were aware of and intended to influence.⁷⁴²

⁷³⁶ This is a situation where a point of law that the court is asked to determine has no judicial precedent.

⁷³⁷ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 85, and *Nycal Corp. v. KPMG Peat Marwick LLP* 688 N.E.2d 1368 (Mass. 1998) at p. 1372.

⁷³⁸ Id (citing *Nycal Corp. v. KPMG Peat Marwick LLP* at p. 1374)

⁷³⁹ 42 Tex. Sup. Ct. J. 597, 991 S.W.2d 787 (Tex. 1999)

⁷⁴⁰ GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 86.

⁷⁴¹ WL 1119947 (Tex. App.-Dallas May 20, 2004) (NO. 05-03-00746-CV), review denied (Dec 03, 2004) (not reported in S.W.3d)

⁷⁴² GRUBBS, J. K. & ETHRIDGE J. R., Auditor Negligence..., op. cit., p. 85.

3. CONCLUSION

The Restatement standard is obviously more generous than the privity rule but it is also narrower than the foreseeability approach.⁷⁴³ Strict privity is contractually based, such as between the auditor and the client. The criteria for the Restatement and “near” privity approaches are very similar. The difference between them is the extent of the relationship required. The “linking conduct” element in the third part of the *Credit Alliance*, “near” privity approach requires not only that the third party be known to the auditor, “but that the auditor either directly convey the audit report to the third person or otherwise act in some manner specifically calculated to induce reliance on the report. In this regard, a mere ‘unsolicited phone call’ by the third party to the auditor is insufficient. The auditor must be aware of a ‘particular purpose’ for the audit engagement and must act to further that purpose....This additional showing is not required by the Restatement test...”⁷⁴⁴

The merit of the Restatement rule lies in a middle ground it represented between a closed door standard of privity and the opened-ended liability of the foreseeability rule. The courts have generally found the privity-based stance of *Ultramares* to be too protective of the public accountants who know the result of their audit will be used to influence specific third parties.⁷⁴⁵ At the same time, the foreseeability of the *Rosenblum* is regarded too open-ended to permit accountants reasonably to predict and manage their liability exposure. Restatement standard is therefore, a preferred choice as “it balances, more so than other standards, the need to hold public accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from a liability that unreasonably exceeds the bounds of their real undertaking.”⁷⁴⁶

⁷⁴³ Id.

⁷⁴⁴ *Bily*’s case *supra* at 755.

⁷⁴⁵ See SILICIANO, J. A., Trends in Independent..., op. cit., p. 349 and in *First Florida Bank v. Max Mitchel & Co.*, 558 So. 2d 9 (Fla. 1990) at p. 15, where the court noted: Because of the heavy reliance upon audited financial statements in the contemporary financial world, we believe permitting recovery only from those in privity or near privity is unduly restrictive. On the other hand, we are persuaded by the wisdom of the rule which limits liability to those persons or classes of persons whom an accountant “knows” will rely on his opinion rather than those he “should have known” would do so because it takes into account the fact that an accountant controls neither his client’s accounting records nor the distribution of his reports.

⁷⁴⁶ Id.

4. LIABILITY OF THE “AUDITORES DE CUENTAS” TO THIRD PARTIES

4.1 SPANISH JUDICIAL CONTEXT

In order to appreciate the doctrinal structure of the Spanish system of liability, it is important to consider the civil law tradition upon which it was built, in particular the French Civil Code. The nineteenth century drafters of the French Civil Code, from where the Spanish Code is derived, sought to embody certain fundamental moral principles. Although with the passage time these moral principles have evolved and embraced other challenges that today, “the law of civil liability not only allows the courts to uphold against those who would disregard the rights already acknowledged to exist, but also contributes to the emergence and protection of rights as yet inchoate and unrecognized. It thus constitutes a method of complementing and improving the legal system and bringing it up to date.”⁷⁴⁷

Auditor’s liability like other civil liabilities in Spain is traditionally divided between contract law and tort. The former, are the parties to the auditor’s contract, and the latter are those third parties that are not parties to the contract but have suffered a loss as a result of it. These third parties could take benefit of tort law to recover their loss. Thus, pursuant to the relevant provision under the Civil Code, section 1902 anyone whose fault or negligence causes harm to someone else is legally obliged to compensate the victim. It is pertinent to point out here that this provision is a progeny of section 1382 of the French Code from which it was derived. In practice it shares the similarity of tort of negligence under the common law. Generally, this legal obligation not to wrongfully inflict harm is owed to the world at large and the nature of the loss as being purely economic or financial is irrelevant in this regard. Moreover, under this system the question of auditors’ liability towards third parties is not dealt with through the application of a specific standard of liability like in the United States, under Spanish law any claim that fulfills the three conditions of recovery in tort, fault, damage and the causal link between the two is *ipso facto* recoverable. This section will give a broad overview of the relevant rules of “responsabilidad civil extracontractual” under this jurisdiction.

⁷⁴⁷ See generally, VAN GERVEN, W. G., LEVER, J. & LAROCHE, P., *Cases, Materials and Text on National, Supranational and International Tort Law*, Oxford: Hart Publishing 2000.

4.2 ARTICLE 26 OF “LEY 22/2015”

4.2.1 BACKGROUND AND HISTORY

Auditors in Spain, like other professionals, may incur liability because of an action or omission by them, which results in a financial loss to their clients or third parties. It is common knowledge that liability of professionals, like auditors in common law jurisdictions, including the United States is fundamentally based on the operation of negligence law. A *stare decisis* or judge made law.

However, in a civil law country like Spain, professional liability naturally has to come from a written law, like the civil code. But the civil code made no mention of the figure of an auditor. In fact, there was no law on auditors or their liability until the promulgation of Ley de Sociedades Anonimas LSA in 1951.⁷⁴⁸ The LSA under its article 108 introduced, for the first time, professionals like Accionistas Cenceros and Cenceros Jurados, widely considered the predecessors of auditors in Spain. Even at that the LSA still fell short of providing for liability.⁷⁴⁹

The first Spanish law to make direct allusion regarding the liability of auditors was in the 1988 Audit Law and the 1989 revision of the LSA that came as result of transposition of an EU law, Directive 84/253/EEC on the approval of persons responsible for carrying out the statutory audits of accounting documents, into Spanish law.⁷⁵⁰ Accordingly, article 11 of LAC in its original version provided that auditors are jointly and severally liable for damages they caused to their clients and third parties as result of their failure to fulfill their obligations. Thus, where the auditor who signs the audit report works in an audit firm all members of the firm shall jointly be responsible for his action.⁷⁵¹ Without a doubt, this article is the single most important law as far as auditor liability in Spain is concern. It is also true that more than the provision of article 11 (now 26), liability of auditors is sanctified under a combination of laws and

⁷⁴⁸ OTERO CRESPO, M., *La Responsabilidad Civil del Auditor de Cuentas*, Aranzadi Thomson, Cizur Menor, Navarra, 2013, p. 189.

⁷⁴⁹ Id.

⁷⁵⁰ Id.

⁷⁵¹ According to OTERO CRESPO, the joint-and-several liability provision found under article 11 LAC was repealed in the financial reforms law, “Ley 44/2002”, in what may be considered as a move to appease auditors. See OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 189 fn. 527.

standards, like LAC, RAC and NTA together with the general principles of private law in 1902 of the CC.

Given the importance of article 11 to our discussion and the evolutionary process it had undergone over the course of time, it is appropriate to briefly recap this process. As stated here, article in its original provision contemplated a joint-and-several liability regime, which was greeted with criticism, especially, PANTALEÓN for being arbitrary and to principle of fairness in the law.⁷⁵² Irrespective of several attempts in the past, the law suffered its first amendment in 2002 through the financial reform law, “Ley 44/2002, de 22 de noviembre, de Medidas de Reforma del Sistema Financiero.” This law, under its article 52, effectively repealed and replaced joint-and-several liability regime of auditors with individual and proportionate liability by interposing the general liability principle obtained under articles 1101 and 1902 of the CC respectively.⁷⁵³ The article also omitted to mention third parties present in the early provision of article 11.

However, a similar provision found under article 42 RAC was left intact together with its provision that liability of auditors is unlimited. Apart from leaving unlimited provision of intact, the LAC also made reference to it that without prejudice to unlimited liability in article 42 RAC.⁷⁵⁴ This provision generated conflicting points of views, with some commentators questioning liability limitation clauses in audit contracts. Others like PANTALEÓN sustained that the unlimited liability refers to the guarantee that auditors are obligated to maintain apart from their liability insurance.⁷⁵⁵ Amendment to the audit law continued until recently with the “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas.”

⁷⁵² PANTALEÓN, F. (1996, p. 25-27) in OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 193.

⁷⁵³ *Id.*

⁷⁵⁴ *Id.* at p. 194.

⁷⁵⁵ *Id.*

4.3 APPLICATION OF THE GENERAL PRINCIPLES OF LIABILITY UNDER ARTICLE 1902 CC

Under Spanish law, plaintiffs to any claim in damages benefit from a general right of action without any *a priori* limitation on the scope or nature of protected rights and interests as long as they are legitimate.⁷⁵⁶ Indeed, from the Spanish law standpoint, it is a *non sequitor* for instance to speak of “protected rights” in an exclusionary sense. Compensation for fault or negligence is not predicated on a prior duty of care towards the plaintiff applicable under the American common law.⁷⁵⁷ Generally, damage is compensated whenever some three prerequisite conditions are met: the defendant has committed a fault, the plaintiff has suffered harm, and there is a causal link between the two events. This unitary approach to the issue of liability does not however prevent flexible judicial decision making. Thus, not every act of the defendant will constitute a fault, and not all harm claimed will be worth compensating. Where, for policy reasons, access to a remedy needs to be denied, the Spanish courts do not hesitate to employ the above three conditions to restrict the extent of the general principle of liability.⁷⁵⁸ Nonetheless, the main device used by the courts to control liability in auditor liability claims by third parties, is the requirement of causation.⁷⁵⁹

In Spain, civil liability in tort is regulated under article 1902 CC. The same article provides the legal basis for civil liability in instances of intentional harm as well as cases of mere negligence. Article 1902 is essentially fault based. Significantly, the notion of fault is deemed sufficiently broad to cover not only positive acts but also omissions by the tortfeasor. Thus, in principle, it ought to make no difference that the blameworthy conduct consists of a failure to act rather than positive action.⁷⁶⁰

⁷⁵⁶ VAN BOOM, W. H., ET AL., (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 62.

⁷⁵⁷ DíEZ-PICAZO, L., “La Culpa en la Responsabilidad Civil Extracontractual”, *Anuario de Derecho Civil*, 54, 2001, p. 1019. MARTIN-CASALS & JOSEP SOLÈ argue that Spanish law does not require proximity as a means to limit the right of individual claimant. VAN BOOM, W. H., ET AL., (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 65.

⁷⁵⁸ *Id* at p. 63.

⁷⁵⁹ *Id*.

⁷⁶⁰ DíEZ-PICAZO, L., *La Culpa en la Responsabilidad Civil Extracontractual*, en “Estudios de responsabilidad civil en Homenaje al Profesor Roberto López Cabana”, Ed. Dykinson, Madrid, 2001, p. 111. The learned author sustains here that the fault concept although it defies precise definition, may be understood as a deviation from the standard behavior accepted in a given society at a given time. See also PUIG BRUTAU, J. *Fundamentos de Derecho Civil*. Tomo II, volumen III, Ed. Bosch, Barcelona, 1984, pág. 86.

Apart from the general principle of liability enshrined in the “Código Civil”, the legislators in Spain had also made explicit provision for auditor’s liability towards third parties. As found under article 26.1 of the new Audit Law, “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas”, which provides:

Los auditores de cuentas y las sociedades de auditoría responderán por los daños y perjuicios que se deriven del incumplimiento de sus obligaciones según las reglas generales del Código Civil, con las particularidades establecidas en el presente artículo.

This provision is a specific application of the general principle of liability enshrined under article 1902 CC. It must however, be interpreted in conjunction with the requirements of proof like, fault, damage, and causation.⁷⁶¹ Hence, the article only re-emphasized the principles already existing in the “Código Civil”. The Spanish legislator by reaffirming these general principles in the area of auditor’s liability towards third parties seeks to make it clear that the third party is not an “indirect victim” whose prima facie right to recovery is in doubt.⁷⁶² Moreover, according to OTERO CRESPO, the publication requirement of the annual report together with auditor’s certificate has by analogy made third parties recipients of the auditor’s report through the Mercantile Registry, thereby made the compensation for the loss they suffered as a result of its use justifiable under the law.⁷⁶³

The specific provision of article 26 of the Audit Law does not by any means make the third party’s claim easier. In practice, the Spanish courts allow themselves plenty of leeway so as to avoid having to order compensation for damage that is too remote.⁷⁶⁴ They usually achieve this by the use of the following elements: action or omission, damage, fault or negligence and causation.⁷⁶⁵

⁷⁶¹ The courts in interpreting article 1902 came to the conclusion in several judgments that to sustain an action in third party claim, there must be concurrence of these three elements, please see *SSTS de 17 de noviembre 1998*, (RJ 1998/8809); *SSTS de 13 de abril 1999* (RJ 1999/2611).

⁷⁶² The figure of third party is treated below at p. 209. See also KHOURY, L., *Liability of Auditors...*, op. cit., p. 450, on the application of similar rule in France.

⁷⁶³ OTERO CRESPO, M., “Algunas Notas en torno a la Responsabilidad Civil de los Auditores Frente a a Terceros Ajenos al Contrato de Auditoría”, *Dereito* 16, 2007, p. 348. See also article 11 RAC.

⁷⁶⁴ DíEZ-PICAZO, L., *Derecho de...*, op. cit., p. 337.

⁷⁶⁵ OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 241.

4.3.1 THE FAULT REQUIREMENT

Fault or negligence as well as damage have been sufficiently treated the first part of this Chapter under pure economic loss the following paragraphs will deal with causation under Spanish law.

4.3.2 CAUSATION REQUIREMENT: CAUSAL NEXUS AS A PREREQUISITE FOR LIABILITY

Causation is a fundamental concept in the civil law system when it comes to proving liability. It presupposes establishing a causal relationship between the conduct of the auditor and the loss of the third party plaintiff. According to OTERO CRESPO, the concept of causation helps the court to determine where to place liability as well as on the extent of the liability.⁷⁶⁶ Either way, the plaintiff must prove that the action or omission of the auditor in certifying the audit report is responsible for the loss he sustained. Thus, in preparing the audit report must have omitted to see an obvious fact, failed to comply with a relevant accounting standard or emit a report that is not in accord with financial state of the company.⁷⁶⁷ As pointed out in the case of *Snell v. Farrell*,⁷⁶⁸ it is said to be an expression of the relationship that must be found to exist between the tortious act of the tortfeasor and the injury to the victim in order to justify compensation of the latter out of the pocket of the former.

According to OTERO CRESPO, the tenor of article 26 LAC is clearly making allusion to the causal nexus between the loss of the plaintiff and breach of the auditor, which requires the concurrence of physical causation and determination of liability by court, known as causation in law.⁷⁶⁹ As indicated above, causation is sometimes viewed in the light of two requirements of damage, namely certainty and directness. The requirement of certainty as recognized by the courts in Spain has been amply discussed in the first part of this chapter under pure economic loss. The latter requirement is derived from article 1107 CC. which reads:

⁷⁶⁶ Id at p. 252.

⁷⁶⁷ Id at p. 242.

⁷⁶⁸ *Snell v. Farrell* (1990) 2 S.C.R. 311

⁷⁶⁹ OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 253.

Los daños y perjuicios de que responde el deudor de buena fe son los previstos o que se hayan podido prever al tiempo de constituirse la obligación y que sean consecuencia necesaria de su falta de cumplimiento.⁷⁷⁰

Although this is a provision that concerns liability for breach of contracts, it has been interpreted as an expression of a general principle applicable to tort law as well. Thus between the act or omission of the auditor and the damage that ensued, there must exist a relation of cause and effect.⁷⁷¹ The causative requirement of this provision has found judicial expression in the case of Lepanto Compañía de Seguros y Reaseguros, SA and Price Waterhouse Auditores, SA,⁷⁷² when the court in reference to instances of third party liability opined as follows:

De los presupuestos de la responsabilidad extracontractual prevista en el artículo 1902 del Código Civil (LEG 1889, 27) , aplicable al caso, tiene particular importancia el referido a la relación causal entre la conducta y el daño.⁷⁷³

There is no express provision under Spanish law with regard to assessment of causation by courts. It only requires the damage to be direct and immediate consequence of the fault. In practice, under the civil law's deductive approach to legal reasoning, general tort principles - including fault - only acquire meaning through their application to individual cases. Of necessity room is made for pragmatism in the process.

It is of common knowledge that the term causation refers to a certain material link between two acts in line with natural law. While in many instances obvious, the determination of causation can be difficult in cases where several factors are susceptible to causing the damage. However, sometimes it may be so complex that it may require intervention of an expert. Different theories have been developed by legal writers and commentators as guidance for the determination of causation. These theories however,

⁷⁷⁰ REGLERO CAMPOS argues here that directness signifies a link between the tortfeasor and the damage to the plaintiff El daño es directo y mediato cuando existe un nexo de causalidad suficientemente fuerte entre el hecho y el perjudicado 'por rebote', con independencia del daño inicial del que se considera autónomo. En consecuencia, este requisito no limita los daños que se consideran reparables... REGLERO CAMPOS, F., (coord.), *Tratado de Responsabilidad Civil*, Ed. Thomas-Aranzadi, Cizur Menor, Navarra, p. 215.

⁷⁷¹ DE ÁNGEL YAGÜEZ, R., *La Responsabilidad Civil*, Universidad de Deusto, Bilbao, 1988, p. 241.

⁷⁷² Sentencia núm. 798/2008 de 9 octubre RJ 2008/6042

⁷⁷³ Id.

are not foolproof and do not always respond properly, to the specific problems encountered in the practical application of the causation requirement by courts.

Although theories abound to provide criteria to resolve the issue of causation, Spanish courts mainly tend to adopt the following theories:

A) CAUSE IN FACT (CAUSALIDAD DE HECHO)

As evidential requirement, this criterion is determined through the sine qua non condition, or ‘but for condition’, it only requires a proof that, but for the breach of contract or tort by the defendant, the claimant would not have suffered the loss. Causation is established if the court comes to the conclusion that the damage would not have occurred, had the fault or negligence not been committed.⁷⁷⁴ When the damage was allegedly caused by an act, the test is whether there would be no such damage if the specific act did not happen. In case the damage was allegedly caused by an omission, the test is whether the damage would have arisen if the defendant had acted in accordance with his duties. The fault or negligence need not be the exclusive cause of the damage, but only its necessary or proximate cause.⁷⁷⁵

This is by far the most widely used criteria for establishing the causal connection required in accord with ordinary moral notions of responsibility, however, INFANTE RUIZ pointed out that there may be occasions when the law deviates from this theory.⁷⁷⁶ For example, if two hunters independently but simultaneously shoot and kill a third person, it is intuitively clear that each should be held responsible for the death. Yet the but-for-test seems to yield to the conclusion that neither has caused the harm. The courts in Spain as well as in America impressed by what they see as a drawback obtained in but-for test moved to accommodate multiple or alternative causes.⁷⁷⁷ This is seen in the celebrated American case of *Anderson v. Minneapolis, St. P. & S. St. R.R. Co.*,⁷⁷⁸ where substantial factor rule was developed as an expansion of the “but for test”. In fact, it was the perceived limitation of the sine qua non doctrine as a causal principle that has led to

⁷⁷⁴ Please see the decision of *SAP Balears of February 23, 2005* (AC 2005, 219).

⁷⁷⁵ A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union

⁷⁷⁶ INFANTE RUIZ, F., *La Responsabilidad por Daños...*, op. cit., p. 143.

⁷⁷⁷ Id. at p. 148.

⁷⁷⁸ 430, 179 N.W. 4 (1920).

advent of the proximate cause or causation in law by the courts to moderate its excesses when appropriate.⁷⁷⁹

Dicha relación se reconstruye, en una primera fase, mediante la aplicación de la regla de la “conditio sine qua non”, conforme a la que toda condición, por ser necesaria o indispensable para el efecto, es causa del resultado; y la de la “equivalencia de condiciones”, según la cual, en el caso de concurrencia de varias, todas han de ser consideradas como iguales en su influencia causal si, suprimidas imaginariamente, la consecuencia desaparece también.⁷⁸⁰

Now with numerous judgments⁷⁸¹ by the Spanish Supreme Court on diverse contexts of causation in law, the doctrine can be said to be well consolidated in Spanish law. This doctrine also enables the courts to cut third party liability to a reasonable limit by filtering section 1902 CC not only through the trio valves of cause in fact, foresight test and negligence but also in the mirror of cause in law.⁷⁸²

Afirmada la relación causal según las reglas de la lógica, en una segunda fase se trata de identificar la causalidad jurídica, para lo que entran en juego los criterios normativos que justifiquen o no la imputación objetiva de un resultado a su autor, en función de que permitan otorgar, previa discriminación de todos los antecedentes causales del daño en función de su verdadera dimensión jurídica, la calificación de causa a aquellos que sean relevantes o adecuados para producir el efecto.⁷⁸³

This line of reasoning is confirmed in a recent judgment where the Spanish Supreme Court⁷⁸⁴ held that the causal relationship contemplated by the Spanish law is not solely limited to natural cause or cause in fact but also a judicial evaluation of the circumstances of the case in apportioning liability, known as causation in law.⁷⁸⁵

⁷⁷⁹ SALVADOR CODERCH, P. & FERNÁNDEZ CRENDE, A., *Causalidad y Responsabilidad*, 3ª ed., Working Paper 329 InDret, 2006, p. 7.

⁷⁸⁰ RJ 2008/6042

⁷⁸¹ See STS 29-11-2006 (RJ 2007, 271) and STS 15-11-2007 (RJ 2007, 8110) among others.

⁷⁸² SALVADOR CODERCH, P. & FERNÁNDEZ CRENDE, A., *Causalidad...*, op. cit., p. 19.

⁷⁸³ RJ 2008/6042

⁷⁸⁴ STS de 2 de marzo de 2009

⁷⁸⁵ JOSEP RIBOT, I., “La responsabilidad extracontractual del auditor en la jurisprudencia: análisis y perspectiva de futuro”, *Aranzadi Civil-Mercantil*, 7/8, 2009, p.13.

Como es bien sabido, la Sala Civil lleva ya varios años aplicando esta doctrina en diversos contextos con lo que parece consolidado el criterio predominante en la doctrina penal y civil según el cual la relación de causalidad que exige la ley no consiste únicamente en la llamada causalidad natural o de hecho sino que también incluye la llamada causalidad jurídica o imputación objetiva.⁷⁸⁶

B) CAUSATION IN LAW (IMPUTACIÓN OBJETIVA)

Under this causation theory, when the cause of damage is a combination of several factors, then the cause is adjudged as total of the contributory sum that had produced the result. In other words, all of the contributing conditions are considered equal in their influence as a cause because by removing anyone of them, the result disappears as well. Here the Plaintiff must establish that the damage sustained by him is the natural and adequate consequence of the Defendant's conduct and that the outcome is probable and reasonably foreseeable to the Defendant. Where the chain of causation is so long or tenuous that the loss is not reasonably foreseeable, the loss is described as too "remote" to be recoverable. The act committed, in addition to having materially caused the damage in question, must be capable of causing this type of damage when considered alone irrespective of the surrounding circumstances. Unforeseeable damage is not recoverable, as held in Sentencia núm. 243/2007 de 19 junio JUR 2008/52859.⁷⁸⁷

Y ello porque para la determinación de la existencia de relación o enlace preciso y directo entre la acción u omisión -causa- y el daño o perjuicio resultante -efecto-, en la que la doctrina jurisprudencial viene aplicando el principio de la causalidad adecuada, se exige, para apreciar la culpa del agente, que el resultado sea una consecuencia natural, adecuada y suficiente de la determinación de la voluntad; debiendo entenderse por consecuencia natural, aquella que propicia, entre el acto inicial y el resultado dañoso, una relación de necesidad, conforme a los conocimientos normalmente aceptados.

En cada caso concreto debe valorarse, si el acto antecedente que se presenta como causa, tiene virtualidad suficiente para que del mismo se derive, como consecuencia necesaria, el efecto lesivo producido, no siendo suficiente las

⁷⁸⁶ Id.

⁷⁸⁷ See Sentencia núm. 243/2007 de 19 junio JUR 2008/52859

simples conjeturas, o la existencia de datos fácticos que por mera coincidencia, induzcan a pensar en una interrelación de esos acontecimientos, sino que es preciso la existencia de una prueba terminante relativa al nexo entre la conducta del agente y la producción del daño, de tal forma que haga patente la culpabilidad que obliga a repararlo.⁷⁸⁸

The yardstick to measure this proof is nonetheless a subject of dispute among legal scholars, whether the test should be subjective i.e. whether the defendant can avoid the outcome or it should rather be objective i.e. whether the outcome is foreseeable to an average person.⁷⁸⁹ In the event of willful misconduct, the auditor shall be liable for all the damages which are known to be the consequence of his breach, whether or not foreseen or foreseeable.⁷⁹⁰

It is trite law that liability goes much farther than occurrence of an action or omission which harms the defendant. In a determination of liability a link must be established between the defendant's conduct and loss of the plaintiff, which is a question of fact to be proved by evidence. The imposition of liability however is a question of law to be determined in accord with public policy.

El nexo de causalidad no puede ser establecido únicamente en el plano fenomenológico atendiendo exclusivamente a la sucesión de acontecimientos en el mundo externo, sino que causalidad física debe ser acompañada de una valoración jurídica en virtud de la cual, con criterios tomados del ordenamiento, pueda llegarse a la conclusión de que el daño causado se encuentra dentro del alcance de la conducta del agente, en virtud de lo que en nuestro ámbito científico suele llamarse imputación objetiva.

Although causation may be established factually, the court may still hold the defendant not liable to the claimant because in the circumstances of the case, defendant is not deemed, in a legal sense, as beholden to the claimant. In a relevant judgment,⁷⁹¹ the Spanish Supreme Court endorsing the Principles of European Torts Law reasoned that

⁷⁸⁸Id.

⁷⁸⁹ SALVADOR CODERCH, P. & FERNÁNDEZ CRENDE, A., *Causalidad...*, op. cit., p. 8.

⁷⁹⁰ Id.

⁷⁹¹ STS de 2 de marzo de 2009.

the determination of causation need not be evidential proof and disproof of facts alone but must of necessity be accompanied by judicial evaluation.⁷⁹² This in essence entails the considerations in law why the defendant may be freed from liability or held liable and to what extent.⁷⁹³

Thanks to the support received from the Spanish Supreme Court in the 1980s, the *sine qua non* approach is the one commonly adopted by the courts⁷⁹⁴ and implies the existence of a direct link between the cause and the damage. However, Spanish legal scholars have most recently favored the application of causation law in the determination of causation. This view has also been admitted by some courts.⁷⁹⁵ It is noteworthy that the Spanish Supreme Court in recent judgments is embracing the cause in law at the expense of the *sine qua non* and foresight theories courtesy of the influence of the Principles of European Torts Law (PETL).

Even though Spanish courts sometimes rely on the theories discussed above, their intellectual process is usually not based on any theoretical ground, logical explanation or a search for mathematical precision. After all, none of the various philosophical theories propounded for the determination of causation, can only on itself, provide a solution to the diverse problems courts are called to resolve. The Spanish Supreme Court observed here that, theoretical discussions on causal relationship are best left with philosophers, and courts in turn must seek for justice by looking at the circumstances of the case at hand rather than a particular theory.⁷⁹⁶ Hence the courts rather rely on judicial evaluation based on common sense application of the law.

⁷⁹² JOSEP RIBOT, I., *La responsabilidad extracontractual...*, op. cit., p.13.

⁷⁹³ PANTALEÓN PRIETO, F., “Causalidad e Imputación Objetiva: Criterios de Imputación”, *Centenario de Código Civil, II*, Ceura, Madrid, 1990, p. 1563.

⁷⁹⁴ STS de 30 de abril de 1998 (RJ 1998, 2602).

⁷⁹⁵ See CHOCLÁN MONTALVO, J. A., “Responsabilidad de Auditores de Cuentas y Asesores Fiscales. Tratamiento Penal de la Información Societaria Inveraz”, Barcelona: Bosch, 2003, 104. STS 29 de noviembre de 2006 (RJ 2007/ 271) and STS de 15 de noviembre de 2007 (RJ 2007/8110) are among the most recent judgments of the Supreme Court bordering on causation in law.

⁷⁹⁶ STS de 25 de enero de 1933.

4.3.3 THE EXTENT OF LIABILITY: PROPORTINATE LIABILITY

According to the provision of article 1107 CC, “auditors de cuentas” shall only respond to losses that are necessary consequences of their personal faults, and they cannot be substituted with the fault of the management.⁷⁹⁷ Commenting on this principle, ESPINOS argues that auditors who have acquiesced by their silence to accounting irregularities, bad practices or manipulations are equally at blame in these manipulations. However, it is also true that they can only be responsible to the extent of their fault.⁷⁹⁸ Thus it is argued that, in their evaluation of “auditores de cuentas” liability courts need to take cognizance of article 1107 CC to make sure that they respond only to the part of the loss directly linked to their fault.⁷⁹⁹ In practice however, there is a discernible tendency to apply the theory of “causalidad adecuada”, and to condemn “auditores de cuentas” with the management.⁸⁰⁰ Moreover, section 26.2 of the revised audit law now advocates for proportionate liability:

La responsabilidad civil de los auditores de cuentas y las sociedades de auditoría será exigible de forma proporcional a la responsabilidad directa por los daños y perjuicios económicos que pudieran causar por su actuación profesional tanto a la entidad auditada como a un tercero.

Finally, the courts have frequently absolved the “auditores de cuentas” of blame when the chain of causation is broken by the plaintiff’s contributory negligence,⁸⁰¹ through the intervention of a third party⁸⁰² ordinary risk of business or force majeure (section 1105 CC). This fact, however, present in every case, does not usually in itself prevent the courts from finding a causal link; rather, such a fact demonstrates the prima facie indirectness of the actions of the “auditores de cuentas” as a cause of the failure of the business and the necessity of applying strictly the requirement of causation.⁸⁰³

Spanish law here shares a concern of indeterminate liability with the common law. As such, this double qualification, in that the loss must be both “certain” and “direct”,

⁷⁹⁷ ESPINOS BORRÁS, A., *La Responsabilidad Civil en las Sociedades Mercantiles*, S. A. Bosch, 2005, p. 247, in practice, “auditor de cuentas” is only liable for the damages he could have foreseen, except in case of willful misconduct.

⁷⁹⁸ Id.

⁷⁹⁹ DÍAZ ECHEGARAY, J. L., *Los Deberes...*, p. 226.

⁸⁰⁰ *SAP of Balears of February 23, 2005* (AC 2005, 219)

⁸⁰¹ *STS de 25 de mayo de 1985* (RJ 1985\2812)

⁸⁰² *STS de 11 de marzo 1988* (RJ 1988\1961)

⁸⁰³ See article 1103 CC, please see also KHOURY, L., *Liability of Auditors...*, op. cit., p. 457.

provides as many safeguards against the granting of a remedy that, mainly from a policy perspective, would be unwarranted. Interestingly, it is a qualification that does not feature in the actual tort provisions of the Code. Rather, it was borrowed from the Code's provision on the law of contract. Specifically, the courts apply article 1261 CC to the law by analogy to fill an existing lacuna in the tort law as contemplated by article 4 CC.

4.3.4 DIRECT LINK WITH THE DAMAGE SUFFERED

Article 1261 CC formally limits entitlements to compensation to proven loss that is certain and a direct result to the harm sustained. Plaintiffs are also required under article 26 LAC to show not only reliance on the audit report but that it was decisive in their decision. Spanish courts have frequently rejected claims where the damage suffered by the plaintiffs is not linked to the “auditores de cuentas” fault. In a recent ground breaking judgment,⁸⁰⁴ the Spanish Supreme Court rejected a claim founded on a disciplinary inaction of the *Comisión Nacional del Mercado de Valores* (CNMV) rather than the reliance placed by the plaintiffs on an erroneous audit report. A third party claim will also fail where the evidence shows that the irregularities would not have been discovered even if the “auditores de cuentas” had exercised their control with diligence and prudence;⁸⁰⁵ when the decision of the plaintiff is based on considerations other than the auditor's fault;⁸⁰⁶ where the detrimental act is directly linked with the administrators of the company;⁸⁰⁷ or there is evidence to show that the plaintiff knew, or had reason to know about the real financial standing of the company.

In the above cited important judgment rendered by the Spanish Supreme Court on October 9, 2008, the plaintiffs, securities investors, sued the “auditores de cuentas” of the Securities Company they had invested in. The company fell into bankrupt after it had been audited by the defendants, which led to the subsequent intervention of the CNMV. The plaintiffs contended that had the audit report reflected the true and fair view of the company it would have prompted the intervention of the CNMV to save their investments. The court held that the protection of the audit law is meant for those third parties that had justifiably relied on the veracity of an audit report, it is not meant

⁸⁰⁴ STS 9 de octubre de 2008 (RJ 2008, 6042).

⁸⁰⁵ Id.

⁸⁰⁶ ALEMANY EGUIDAZU. J., Auditoría Legal..., op. cit., p. 384.

⁸⁰⁷ STS 1ª de 11 de marzo de 1988.

to draw the attention of a public regulation agency to save those who invested in the market. In other words, the bad investment decision of the plaintiffs was not based on the strength of the audit report, which they did not know of. Meanwhile there are many factors that could cause the intervention of the CNMV, when the regulatory agency deems it necessary.

The plaintiffs' in the above case failed mainly on wrong pleadings. The strength of their case should have been on the reliance they had placed on the erroneous audit report and how that caused their loss other than it had failed to reveal the actual financial situation of the company to the regulatory body.

4.3.5 ASSESSMENT OF CAUSATION

Finding a proper measurement for determining causal links between the complained act and the damage had always proved a hard task for the courts, and the specific area of auditors' liability towards third parties presents even more difficulty in meeting this requirement. First, the conduct of the "auditores de cuentas" in majority of cases is one of omission rather than of positive action, which creates some evidentiary difficulties. Nonetheless, OTERO CRESPO argues that two possible conducts are contemplated on the part of the auditor. Thus, either an auditor gives out a report with incorrect information or where, on the other hand, the failure to include some information makes the report erroneous.⁸⁰⁸ Whatever the case may be, the auditor's conduct must be shown to be false or deceptive and capable of causing the plaintiff's loss.

Second, experience demonstrates that in these types of cases there is a concurrence of factors that lead to misstatements. Traditionally, preparation of accounts is a responsibility saddled with the management of the company,⁸⁰⁹ and "auditores de cuentas" have the obligation not to participate in the management of the company.⁸¹⁰ Consequently, they are not the only ones to blame for the loss suffered by the company or the third party. More often than not the fault flows primarily from the lack of care or

⁸⁰⁸ OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 241.

⁸⁰⁹ Article 171 of LSA mandates the preparation of the accounts of the company on the management.

⁸¹⁰ This is however, not to underestimate concern in some quarters that auditors may come under the sway of important clients as evidenced by the recent financial failures of companies when their auditors looked the other way to imminent misleading accounts.

the fraud of the administrators, auditor's only error is probably the failure to discover this fact. For this reason, the Spanish law prescribes proportional liability between auditors and administrators of the company wherever possible.⁸¹¹ As held in *Euskal Air* as follows:

No se puede descartar *a priori* en absoluto que los auditores sean corresponsables civiles junto con otra personas, que toman decisiones, cuando no han cumplido correctamente sus obligaciones contractuales, por esa labor primordial que tienen en la fiscalización de las cuentas y por la confianza que inspiran sus informes, y en el supuesto concreto esto es lo ha acaecido, en que la conducta de la sociedad auditora generó los perjuicios que se han concedido, como indica la sentencia apelada y mantendremos más adelante. Por último, recalcar que doctrinalmente se admite la posibilidad, lógica lo demás, de que pueda existir una responsabilidad solidaria entre administradores y auditores cuando ambos son los causantes del daño producido.⁸¹²

This decision and the statute that followed thereafter limiting the liability of auditors perhaps answer the call by auditors for legal protection against the third party plaintiff who take undue advantage of the so called deep pocket of auditors. Arguably, it also gives credence to the reluctance shown by courts to allow recovery in favor of third parties on grounds of causation even when the “auditor de cuentas” was at fault.⁸¹³

Moreover, the extent of reliance placed by the third party claimant on the audit report is hard to measure and require a subjectivity test something very difficult to overcome.⁸¹⁴ Finally, the complexity of factors that inform third party's decision and the difficult process of discerning whether or not the damage suffered by him was as a result of reliance on the audit report or was occasioned by the inherent risk of the financial market. All these considerations imply how complex and demanding is the

⁸¹¹ Please see article 26.2 LAC for the provision of proportionate liability. The said article reads “La responsabilidad civil de los auditores de cuentas y las sociedades de auditoría será exigible de forma proporcional a la responsabilidad directa por los daños y perjuicios económicos que pudieran causar por su actuación profesional tanto a la entidad auditada como a un tercero.” It must be noted that this provision is as a result of the recommendation of June 5, 2008 of the European Commission.

⁸¹² SAP de Álava de 4 de noviembre de 2003 (AC 2004, 329).

⁸¹³ Since the work of the “auditor de cuentas” is not meant to provide certainty, it should normally be only one of the factors involved in the assessment of the financial situation of a business.

⁸¹⁴ PACHECO CAÑETE, M., Régimen Legal..., op. cit., p. 357.

determination of the causal nexus in the Spanish legal tradition where it is required to be certain and direct, thus giving no room for doubt. The perceived difficulty in meeting the high standard of certainty and exactitude prompted some authors to suggest a move by the Spanish courts to a more flexible standard of proof. In a manner that causal link need not be demonstrated with scientific exactitude, but that the court at the end is convinced of the probability of its existence.⁸¹⁵

In assessing whether or not there is a causal nexus, Spanish courts usually apply an objective reasonable man standard.⁸¹⁶ The test is whether the “auditor de cuentas” under consideration, exercising the care and skill reasonably to be expected of a normally diligent and prudent professional of his calling and station would have permitted the plaintiff to avoid the loss.⁸¹⁷ A causal connection is not considered to exist if the damage would have occurred, regardless of whether the auditors had discovered the unsatisfactory state of affairs of the company or not.⁸¹⁸ According to CARVAJAL, apart from the reliance burden placed on the plaintiff, he must also establish that he had correctly interpreted the report and that the fault of the “auditor de cuentas” provoked his error in the evaluation of the finances of the company. Lastly, he would have taken a different decision had the audit report been otherwise.⁸¹⁹ In some instances, the evidence that the plaintiff’s could not take any measure to prevent or mitigate the damage could strengthen causation.

It is noticeable that the courts do not require the fault of the “auditores de cuentas” to be the only or even the main cause of the plaintiff’s loss.⁸²⁰ Such an approach would have the consequence of making almost every case inadmissible. Third parties loss may be

⁸¹⁵ DE ÁNGEL YAGÜEZ, R., *Algunas previsiones sobre el futuro de la responsabilidad civil*, Civitas, Madrid, 1995, pp. 77-79 and DÍAZ ECHEGARAY, J. L., *Los deberes y la responsabilidad civil de los auditores de cuentas*, Ed. Thomson Aranzadi, Cizur Menor, Navarra, 2007, p. 358.

⁸¹⁶ A general description of this objective standard may be as follows: he is an ordinary member of the profession, an average, prudent and diligent auditor, who follows good auditing practices as any reasonable person would, and who has the professional skills and knowledge that allow him to be referred to as a reasonably competent member of his profession.

⁸¹⁷ This is also the requirement for the proof of negligence under article 1104 CC.

⁸¹⁸ Here, DE ÁNGEL argues that to establish liability of “auditores de cuentas”, it is not sufficient to prove the existence of fault or a loss but that the second was necessarily occasioned by the first. DE ÁNGEL YAGÜEZ, R., *La Responsabilidad...*, op. cit., p. 241

⁸¹⁹ CARVAJAL TORRE, J., “La responsabilidad de los Auditores de cuentas”, *Revista Técnica del Instituto de Censores Jurados de Cuentas de España*, 5, 1994, p. 20.

⁸²⁰ PETIT LAVALL, M. V., *La Responsabilidad Civil del Auditor de Cuentas Frente a Terceros*, En *Derecho de Sociedades. Libro homenaje al profesor FERNANDO SÁNCHEZ CALERO*, vol. II, McGraw Hill, Madrid, 2002, p. 2232.

occasioned through multiple of causes and lie, at the outset, in the fault or fraud of the administrators. But since it is the function of the “auditores de cuentas” to inspire confidence of users, auditors can therefore be considered as coauthors of the annual report.⁸²¹

In making a liability decisions, the courts also consider the expertise of the plaintiffs to come to the conclusion of whether the plaintiffs could, or should, have discovered the irregularities themselves.⁸²² The courts could also look out to whether the plaintiffs failed to exercise reasonable care in relying on the accounts or they wrongly interpreted the audit report or they took a wrong decision relying exclusively on the audit without considering other factors like the market condition or that the administration of the company have interfered with the defendant’s work, which have contributed to the damage, to apportion the damages between them.⁸²³

In a similar vein, in the French case law, the Court of Appeal of Paris on February 1, 1984⁸²⁴ held that the plaintiff shall only be entitled to the part of the compensation for contributory negligence on his part. In this case a company seeking financing to overcome its difficulties signed an agreement with the plaintiff, rescuer. After the general assembly approved the certified accounts, the plaintiff invested in the company. Three months later, the plaintiff, by then the principal shareholder and officer of the company, discovered grave irregularities in the accounts of the company. The court held that the auditors are only liable for half of the damage suffered by the plaintiff. After stating that he had the right to rely on the certified accounts, the court criticized the plaintiff’s attitude as being careless and imprudent, since he did not, before getting involved, verify the values indicated on the accounts, carry out a thorough accounting verification, or seek information from accountants and the auditors. Moreover, the court believed that he should have requested a more recent statement, since the financial statements were already six months old by the time of his investment.

⁸²¹ See *SAP Álava of November 4, 2003* (AC 2004, 329)

⁸²² PACHECO CAÑETE, M., Régimen Legal..., op. cit., p. 359-360.

⁸²³ PANTALEÓN PRIETO, F., La Responsabilidad Civil..., op. cit., p. 48.

⁸²⁴ KHOURY, L., Liability of Auditors..., op. cit., p. 460.

4.3.6 THE THIRD PARTY FIGURE (EL TERCERO)

The third party figure is well recognized under Spanish law as seen in the above quoted provision of article 1257 CC, where third parties can enforce contracts made for their benefit. In addition to their right under third parties contract in article 1257 CC, third parties may sue under the general tort liability clause found under article 1902 CC. The same figure “tercero” is repeated under article 113 of the Spanish Penal Code as follows:

“La indemnización de perjuicios materiales y morales comprenderá no sólo los que se hubieren causado al agraviado, sino también los que se hubieren irrogado a sus familiares o a terceros.”

Although this law is found under criminal code, it is considered in Spain as universal and applicable to all tortuous liabilities.⁸²⁵ Thus, third party figure in Spain is trite law, but who is a third party under the law and the reach of “tercero” concept has been subject of debate among legal authors and commentators.

Literally, third parties can be defined as parties outside the realm of the audit contract. ALEMANY, on the other hand, defined third parties as those who are excluded for not being part of the contract “ni por intervencion ob origine ni por sucesion universal.”⁸²⁶ However, this does not mean that third party definition is without legal intricacies, given that even the audit law since its debut in 1988 has undergone several amendments, especially, auditor liability regime. As seen above on our discussion on article 26, the reference made to third parties in the original article 11 was completely eliminated by article 52 of Ley 44/2002 and replaced with reference to articles 1101 and 1902 CC.

The debate actually began with the original article 11 over the extent of its reach. Authors like PETIT LAVALL and ARANA GONDRA consider third parties as whoever can prove damage from a negligently performed audit report.⁸²⁷ PANTALEÓN on the other

⁸²⁵ VAN BOOM, W. H., ET AL., (eds.), *Pure Economic Loss: Tort...*, op. cit., p. 63.

⁸²⁶ ALEMANY EGUIDAZU, J., *Auditoría Legal. Due Diligence y Opiniones Legales en los Negocios Mercantiles*, Ed. Thomson-Civitas, Madrid, 2008, p. 142.

⁸²⁷ See PETIT LAVALL(2009) and ARANA GONDRA (1995) in OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 232.

end maintained his thesis that third parties should be a determined group.⁸²⁸ Third party has been duly defined in the 2010 amendment to the LAC and remains the same under article 26.2 of “Ley 22/2015” as:

“cualquier persona física o jurídica, pública o privada, que acredite que actuó o dejó de actuar tomando en consideración el informe de auditoría, siendo éste elemento esencial y apropiado para formar su consentimiento, motivar su actuación o tomar su decisión.”

The same definition is repeated under article 22 RAC but OTERO CRESPO believe that definitions should not supplant the court’s labor of interpretation and assessing case by case circumstances in determining liability.⁸²⁹ The learned author further argues that it is unnecessarily repetitive and its requirements that the audit report should be the determining factor in third party’s decision has the excluded creditors.⁸³⁰ Moreover, creditors can proceed against auditors through contractual door under article 240 of the LSC. In this sense Spanish law accords the same right of action against the company as its members under article 236 LSC. As such members cannot proceed against the company as “terceros” under article 1257 CC. In interpreting third party beneficiary right under article 1257, Spanish courts have held that “el contrato de auditoría concertado entre la sociedad y la entidad auditora no contiene estipulaciones en favor de los socios en calidad de terceros.”⁸³¹ This position, according to OTERO CRESPO contrasts with the German doctrine where members may sue the company for wrong information under third party protection law.⁸³²

Meanwhile, Spanish courts in other important judgments on auditors’ liability have held third parties to include, creditors, shareholders, investors and members of a cooperative.⁸³³ In the light of the above quoted judgment, one may conclude that the case of PSV brought by members of the company as third parties was a remedy that should have been more appropriately pursued under contract. Therefore the decision

⁸²⁸ PANTALEÓN, F. (1995) in OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 232.

⁸²⁹ OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 235.

⁸³⁰ OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 234.

⁸³¹ STS de 27 de mayo de 2009.

⁸³² OTERO CRESPO, M., *La Responsabilidad Civil...*, op. cit., p. 238 fn. 663.

⁸³³ These cases are analyzed below.

reached that members of the same company have a *locus standi* as third parties was *per incuriam*, with all due respect.⁸³⁴

5. JUSTICE ACCORDING TO THE LAW: SPAIN'S RESPONSE TO ECONOMIC LOSS PLEA

It has been argued in some quarters that exclusionary rule on economic loss that has characterized the laws of countries with common law lineage had not in any way produced a downward trend in litigations on the subject. It is rather the countries of civil law heritage, where rights to recovery of economic loss are not classified according to their importance, that have rather had less litigation to contend with in terms of economic loss cases. Spain falls under the second category. Liability of auditors to third parties in Spain was a sterile doctrinal debate by academics as well as legal scholars with rarely any judgment on the subject, especially at the Supreme Court level. The long wait ended recently with the three successive high profile cases of XM Patrimonios, PSV and Euskal Air where the highest court pronounced on the subject. These cases are analyzed below.

5.1 XM PATRIMONIOS STS 9 DE OCTUBRE DE 2008 (RJ 2008, 6042)

This is the maiden case involving question of auditor's liability to third parties to reach the Spanish Supreme Court. It was an appeal from Barcelona High Court where the court affirmed the decision of the court of first instance. Unsatisfied with the decision, the shareholders of XM Patrimonios, further appealed to the supreme court. The simple fact of the case was that auditors of XM Patrimonios, Price Waterhouse Coopers (PwC) gave a favorable report in their audit of the company's accounts of 1993 financial year presented to *Comisión Nacional del Mercado de Valores* (CNMV). In the report PwC have failed to mention the fact that some of the investor funds have been diverted by the Manager of the Security firm. The shareholders brought this action against the audit firm for failure to detect the irregularities in the accounts.

⁸³⁴ STS de 14 de octubre 2008 (RJ 2008, 6913).

The fact in issue that the supreme was asked to determine was whether there was a causal relationship between the audit report of the Respondents and the Appellants' loss. The Appellants argued that had the irregularities been detected and made public by audit report, the CMNV might have acted in time to prevent their loss. The Supreme Court rejected the above argument and held the auditors not liable because the protection offered by the Spanish audit law is to those persons who justifiably relied on erroneously performed audit report or failure on the auditor's part to detect irregularities negligently. The Appellants have complained of neither situation. In other words, the Appellants were unable to convince the court that their loss has a link with the auditor's report either because of reliance or in other form. The appeal failed.

5.2 PSV STS DE 14 DE OCTUBRE 2008 (RJ 2008, 6913)

Here the workers' union UGT formed a cooperative to promote a low cost housing project across Spain. The project became paralyzed midway into construction, mainly because the Managers of the venture fraudulently diverted the funds of the cooperative to their private companies. This fact was not reflected on the audited accounts presented to the members at the Annual General Meeting. Members of the cooperative sued Ernst & Young and Allianz, the insurance company. They demanded for the additional cost they had to pay for the delay in the construction work which they attributed to the negligence of the auditors. The Plaintiffs succeeded at the court of first instance. On appeal to the Madrid High Court the decision was reversed. The high court exonerated the auditors and held that the conduct of the Managers was the cause of the delay.

On further appeal to the Supreme Court, the apex court reversed the Madrid High Court's decision and reaffirmed the lower court's decision. In its judgment the court applied the equivalence of causation theory and reasoned that although the auditors did not cause the delay in the construction, they had contributed to it. The evidence revealed that for several years the auditors have failed to reflect the dire financial situation and mismanagement of the cooperative in their audit report. The court here, drawing a line of difference between causation in fact and causation in law, concluded that liability could be attributed to the auditors for denying the members of the cooperative the correct information and the opportunity to make the right decision. The court granted the appeal against the auditors and the insurance company. They were both ordered to

pay the sum of 1, 955,049.45 Euros being the judgment sum plus accrued interest and costs.

5.3 EUSKAL AIR STS 5 DE MARZO DE 2009 (RJ 2009, 1631)

On similar facts, the Receivers of the bankrupt Euskal Air brought this case against PwC for its favorable audit report on the company's 1990 fiscal year accounts. The plaintiffs alleged that the audit report should have been unfavorable because the then assets of the company were less than half the assets accredited by the audit. They therefore demanded the difference between the company's assets on dissolution and its presumed assets had the auditors adverted to its imminent collapse. The court of first instance gave reason to the Receivers. The auditors appealed.

The Appellants argued that their relationship with the company was contractual and the Respondents were strangers to the contract. The court citing section 11 (now section 26) LAC rejected their argument and stressed that third parties can also sue under the said section. The Supreme Court analyzed various theories of causation before arriving at a decision. It concluded that causation in law is the most relevant doctrine applicable because it gives objective approach to judicial consideration. The court finally rejected the appeal and concluded that loss based on reliance on wrongful audit report is what the law is out to prevent with tort liability provisions.

In fact, the disproportionate audit liability issue forms part of the arguments adduced in the above cases. The liability question still remains a battle ground aside from the clear provisions of article 26 LAC. Litigants still appeal to it in order to avoid liability. Despite its attraction, the argument of Professor PANTALEÓN that article 26 LAC only protects a determined third party is yet to make significant adherents.⁸³⁵ The learned author employing the duty of care test observed that the auditor cannot be negligent to the whole world, but only to determinable receivers of the audit report. This will suppose a reduction of the risk faced by auditors and stability in the audit market.

⁸³⁵ PANTALEÓN PRIETO, F., *La Responsabilidad Civil de los Auditores: Extensión, Limitación, Prescripción*, Civitas, Madrid, 1996, p. 118.

But this is a civil law system where general principle of liability is the norm although proof is all together a different ball game. Hence, in the Euskal Air case above, the Supreme Court did not mince words in clearly rejecting the allusion to contract as the only medium for remedying audit liability. Certainly this may not be the end of economic loss plea in Spain but the Supreme Court has faithfully demonstrated that justice is according to the law. However, it is pertinent to point out that following the transposition of the European Parliament Directive 2006/43/CE into the new Spanish audit law, proportionate liability is now part of Spain's law.

If anything, these judgments signify the importance of prudence and informed judgment when it comes to investing in a volatile market like that of securities. Equity aids the vigilant not the indolent - as the saying goes! Moreover, “owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.”⁸³⁶ Hence, it is generally imprudent for the plaintiff not to undertake a verification of the financial information contained in the statements. While these decisions are striking, considering the weight given by the law to the certification of the French “*commissaires aux comptes*”, this type of argument is widely found in the cases and has been approved by some commentators, who emphasize that certification is not insurance.⁸³⁷

6. CONCLUSION: SIMILARITIES WITH THE COMMON LAW

From the onset, a third party plaintiff in Spain is not preoccupied with considerations of duty or restriction related with economic loss. The system guarantees a general principle of liability as enshrined in articles 1101 CC and 1902 CC respectively. All damages are prima facie recoverable once the elements of liability can be proved – usually fault based. This is in contrast with the US system where liability is generally restricted to contract. Hence a third party plaintiff must prove the existence of duty between himself and the defendant to succeed. Moreover, economic loss actions are also restricted. Apart from these general doctrinal differences, the two systems share much in common. For

⁸³⁶ The auditor's responsibilities relating from fraud in an audit of financial statements, ISA: October, 2008.

⁸³⁷ KHOURY, L., Liability of Auditors..., op. cit., p. 460.

instance, in a recent judgment, the Supreme Court of Spanish placed importance on the absence of reliance on the statements.⁸³⁸ Moreover, some judgments have incorporated considerations similar to the notions of causation in fact and in law, remoteness of damage and proximate cause respectively in their interpretation of the general principle of responsibility in Spain.⁸³⁹ Finally there are arguments by contemporary Spanish legal scholars in favor of limiting the auditors' liability to instances where auditors know or can foresee the specific plaintiff or class of plaintiffs to whom the accounts will be communicated, and of the transaction in contemplation.⁸⁴⁰

⁸³⁸ RJ 2008/6042 *supra*.

⁸³⁹ PANTALEÓN PRIETO, F., *Causalidad e Imputación...*, op. cit., p. 1561.

⁸⁴⁰ PANTALEÓN PRIETO, F., *La Responsabilidad Civil...*, op. cit., p. 80.

CHAPTER IV

PUBLIC AUDIT OVERSIGHT AFTER ENRON: COMPARISON OF INNOVATIONS IMPLEMENTED IN THE US AND EU

1. INTRODUCTION

The marriage between modern economies and financial markets is not of convenience but of necessity. To say that financial markets depend on sound financial statements is an understatement; they are the main thrust of financial markets. Accounting by companies does not only serve the managements of companies that undertook them but also the wider public interest, which may include the stability of a country's economy. Invariably, the decision by investors to invest or divest capital from a given country depends on the trust they place on the quality of its audit. If investors cannot trust financial statements coming out from companies, the companies will no longer have access to the capital they need, which in turn would deprive the said economy of necessary portfolio investment. So to protect investors and the users of financial statements by ensuring that information that emanate from companies to the public were credible was the rationale behind audit regulation.

Accounting and auditing today is a hallmark of an irrepressible innovation undertaken over the time to suit the ever evolving needs and opportunities of investors.⁸⁴¹ This, perhaps, points to the fact that the corporate paradigm, like any other human endeavor is not immutable, so long as expectation gap cannot be closed forever. We may well have to be adjusting corporate rules to accommodate our immediate as well as the foreseen future challenges. As DOTY argues, "as the moment passes, we change it to suit the next."⁸⁴² Thus, whenever audit standards set by the audit regulatory authorities cannot prevent audit failures due to lapse of time or development in the market, it is logical that societies should intervene and revise these standards or their laws to keep pace with the markets.

⁸⁴¹ Capital and Adventure: The Auditor's Role in the Modern Corporation, Address by DOTY, J. R., Chairman, International Forum of Independent Audit Regulators (IFIAR), London, England, Oct. 1, 2012.

⁸⁴² Id.

As indicated in Chapter I, it is relevant to emphasize that audit oversight can hardly be discussed in exclusion of corporate governance. In discussing audit oversight as it affects corporate governance, perhaps, the logical starting point is to present, by way of introduction, a historical background of corporation as we know it today. The modern corporation is a product of the ancient need to amass large sums to finance high-risk trading expeditions across oceans.⁸⁴³ These types of expedition, usually capital intensive, cannot be sponsored by a single individual. Therefore a group of people with similar interests, acting as a body, will come together and gather the capital required to embark on the expedition.⁸⁴⁴ In England, for example, many of such voyages were financed by the Crown. It is a common knowledge that various European nations had also financed such types of expeditions. Some of these trade missions included the Dutch East India Company, the British East Indian Company and the Hudson's Bay Company,⁸⁴⁵ and the Royal Niger Company in Nigeria among others.

We may think of globalization as a 20th century phenomenon. But arguably, globalization began much earlier than its reckoning, especially in the area of trade and exchange. As European nations transformed from agricultural economies to mercantile and manufacturing activities, private international trade flourished.⁸⁴⁶ In the 14th century, for example, England began exporting manufactured goods to Prussia, the Netherlands, and Scandinavia. Thus, according to DOTY, centuries ago international trade became more significant to the British economy than the domestic trade.⁸⁴⁷ Even then, there were evidence of some form of auditing.⁸⁴⁸

The role of auditors nonetheless, became more pronounced in the immediate aftermath of the Industrial Revolution, a period when Europe witnessed high economic growth that eventually led to the transformation of once small family business enterprises into large industrial corporations.⁸⁴⁹ These corporations later metamorphosed into joint stock

⁸⁴³ Id.

⁸⁴⁴ ISMAIL ADELOPO, *The Impact of Corporate Governance on Auditor Independence: A Study of Audit Committees in UK Listed Companies*, Unedited PhD Thesis, De Montfort University, 2010, p. 15

⁸⁴⁵ Id.

⁸⁴⁶ DOTY J. R., *The Auditor's Role*, supra.

⁸⁴⁷ Id.

⁸⁴⁸ Id.

⁸⁴⁹ GROFF, M. Z & HOCEVAR, M., "Public oversight of the audit profession – Comparison of implemented practices in the EU and the U.S"., *Uprava, Letnik VII*, 3/2009, p. 62.

companies, the precursor of the modern-day public company.⁸⁵⁰ The increasing popularity of the joint stock companies, the separation of ownership and management and the demand by shareholders of independent information on how a company they partly own but not controlled is run, gave rise to the modern auditing.⁸⁵¹ Over time, auditors came to symbolize transparency on the part of the companies as well as invaluable agents of the shareholders.⁸⁵² The information they provide to the public became the most credible yardstick used by investors and creditors to measure the performance of the companies. This trust placed by third parties on auditors usually is the only thread that links them with their investments. As observed by a prominent securities lawyer, BLACK as follows:

A strong public securities market, especially a public stock market, can facilitate economic growth. But creating strong securities markets is hard. That these markets exist at all is almost magical. Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and on the honesty of other people, about whom the investors know almost nothing. This magic does not appear in unregulated markets.⁸⁵³

The relevance of the above analysis on this chapter is that the U.S. accounting profession emerged from that groundwork. By the last quarter of the 19th century, the first major accounting body was established in the U.S., being American Association of Public Accountants, the lineal predecessor of the American Institute of Certified Public Accountants.⁸⁵⁴ This was followed in 1896 by the New York state by passing the first law to recognize the qualification known as Certified Public Accountant, which, as CAREY writes, “marked the beginning of an accredited profession of accounting in the United States.”⁸⁵⁵ As financial statements became popular in the 1920s, audit work

⁸⁵⁰ DOTY J. R., *The Auditor's Role*, supra.

⁸⁵¹ DRAKE, H., *The Legal Regulation of the External Company Auditor in Post-Enron South Africa*, Master of Laws Thesis (Inedited), University of Stellenbosch, South Africa, 2009, p. 3, accessed July 7, 2011 at scholar.sun.ac.za/bitstream/.../Drake,%20H.pdf

⁸⁵² Id.

⁸⁵³ BLACK, B. S., “The Core Institutions that Support Strong Securities Markets”, Stanford Law School, Working Papers, 200, 2000, p. 1.

⁸⁵⁴ ZEFF, S. A., “How the U.S. Accounting Profession Got Where It Is Today: Part I”, *Accounting Horizons* Vol. 17, No. 3 September 2003, p. 190.

⁸⁵⁵ Id (quoted from CAREY J. L., 1969, p. 44).

blossomed. Increasing number of listed companies began to issue audited financial statements. By 1926, more than 90 percent of industrial companies listed on the New York Exchange were audited,⁸⁵⁶ even though the New York Stock Exchange (NYSE) did not require audited statements until 1933.⁸⁵⁷ Yet in some ways, the NYSE had encouraged companies to publish their audited financial statements.

With further development of financial markets, the provision of an independent opinion on the financial statements to the general public became the primary objective of an audit. Financial statements came to play a key role in the financial markets, which are essential source of funding to businesses and the heartbeat of the industrialized nation's economy. Given the assurance role they play, auditors were recognized as professionals who act in public interest. The main objective of their work therefore changed from informing the management of inadequacies in the company to ensuring accurate financial disclosures to investors who entrust the companies with their capital. Audited financial statements assumed a crucial role in the functioning of capital markets because the auditing process reduced the information gap between the management and diverse groups of players on capital markets. But who would ensure that auditors remained committed to their founding objectives? We would find out in the following paragraphs.

2. INVESTOR PROTECTION AND AUDIT CONTROL

2.1 THE REGULATION VACUUM

The debate and search for adequate measure of control over the audit profession has been a recurrent decimal right from the humble beginning of the profession. In Chapter III, we discussed audit expectation gap and how it contributes to growing number of cases against auditors. Among the myriad of problems highlighted as responsible for this gap, chief among them was leaving auditors to set their own rules. Incidentally, this is not a novelty. At the hearings held by U.S. Senate Committee on Banking and Currency on the heels of the 1929 market crash, one of the central questions addressed was, if financial statements were to be made obligatory, “what assurance the public

⁸⁵⁶ Id. at p. 191 (citing MAY, G. O., 1926, p. 322).

⁸⁵⁷ Id (citing RAPPAPORT, L. H., 1963).

would have that those statements were reliable.”⁸⁵⁸ Another option considered was whether to require periodic government audits of companies’ financial statements. An alternative was the proposal of the accounting profession which rooted for independent auditors to certify companies’ financial statements. In the arguments that ensued in the course of the Committee hearings, Senator BARKLEY, one of the skeptics of audit profession proposal engaged in an intense exchange with Col. CARTER, the senior partner of Haskins & Sells and the president of the New York State Society of Certified Public Accountants. The outcome of their exchange went on to determine the future of audits in the United States, which is still relevant today. Some recount of their exchange is reproduced below:

Sen. Barkley: Is there any relationship between your organization with 2,000 members and the organization of controllers, represented here yesterday with 2,000 members?

Col. Carter: None at all. We audit the controllers.

Sen. Barkley: You audit the controllers?

Mr. Carter: Yes; the public accountant audits the controller’s account.

Sen. Barkley: Who audits you?

Mr. Carter: Our conscience.⁸⁵⁹

Whether Col. CARTER’s assertion of auditors acting in accord with good conscience is true is subject to proof in the following paragraphs. It may however, be safe to argue that the role they played in some of these monumental financial scandals is anything but conscionable. Be that as it may, finally, Col. CARTER, on behalf of the audit profession, succeeded in convincing the Committee on Banking and Currency, to allow the private sector instead of government agency to undertake audit of companies under the

⁸⁵⁸ NIEMEIER , C. D., Independent Oversight of the Auditing Profession: Lessons from U.S. History, German Public Auditors Congress, Berlin, Germany, November 8, 2007, p. 2.

⁸⁵⁹ Id.

Securities Acts under consideration.⁸⁶⁰ That was how government takeover of public companies' audits was averted in what was to become the first most important legislation on audit of financial statements, the Securities Act of 1933. This was followed by Securities Exchange Act of 1934, which created the Securities and Exchange Commission and vested it with the authority to establish accounting principles to be applied in preparing those financial reports.⁸⁶¹ Moreover, the Securities Acts, by requiring that all companies have their financial statements audited by independent CPAs elevated the accounting profession and increased the demand for its services. But it was how the SEC used its founding authority that is crucial in the history of the audit accounting in the U.S. and perhaps in the world at large. This sentiment was echoed by NIEMEIER as follows:

While seemingly delegating a great part of that authority to the profession, to my mind the Commission's early policy is better described as abandoning the profession to the vagaries of client pressures, thus suppressing the conscience of the profession instead of protecting it.⁸⁶²

With its new status, the American Institute of Accountants went on to merge with its rival association, the American Society of Certified Public Accountants to form the American Institute of Certified Public Accountants (AICPA), thereby consolidating into one national body.⁸⁶³ The SEC on the other hand, notwithstanding its statutory mandate, chose to empower the accounting profession to establish accounting requirements.⁸⁶⁴ This measure taken by the SEC, however, was not devoid of critics even within the Commission.⁸⁶⁵ Yet the Commission went ahead to permit companies the use of accounting practices for which there was "substantial authoritative support" as approved

⁸⁶⁰ ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 192. Generally, see CAREY J. L., *The Rise of the Accounting profession: From Technician to Professional 1896-1936*, New York, American Institute of certified Public Accountants, 1969 and WIESEN, J., *The Securities Acts and Independent Auditors: What Did Congress Intended*, New York, American Institute of certified Public Accountants, 1978.

⁸⁶¹ NIEMEIER, C. D., *Independent Oversight...*, op. cit., p. 2.

⁸⁶² *Id.* at p. 3.

⁸⁶³ ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 191.

⁸⁶⁴ NIEMEIER, C. D., *Independent Oversight...*, op. cit., p. 3.

⁸⁶⁵ According to NIEMEIER, although, this is the majority view, two commissioners –Robert Healy and William O. Douglas, who had joined the Commission staff in 1934 as Supervisor of Study on Protective and Reorganization Committees, and became a member of the Commission itself in 1936 and Chairman in 1937 – were not in agreement with this setting. *Id.*

and published by the Institute's Committee on Accounting Procedure,⁸⁶⁶ the origin of the "generally accepted accounting principles" used today.⁸⁶⁷

The accounting profession, with leave of the Commission also established a standing committee on auditing standards, even though right from the beginning there were signs of the accounting profession's inability to stand up to senior management, as evidenced by the accounting fraud at McKesson & Robbins in 1939.⁸⁶⁸ In that case, the management of McKesson & Robbins inflated its inventories and receivables after their expropriation of the company's funds to the tune of \$20 million. Their auditors, Price Waterhouse failed to neither confirm the receivables nor test the inventories thereby missing the fraud committed by the management. The scale of this scandal hugely embarrassed the accounting profession, as the Editor of the Institute's *Journal of Accountancy* wrote in February 1939, "Like a torrent of cold water the wave of publicity raised by the McKesson & Robbins case has shocked the accountancy profession into breathlessness."⁸⁶⁹

In the investigation carried out by the SEC to unearth the cause of the scandal, it was concluded that the overstatement of the management "should have been disclosed...if the auditors had corroborated the company's records by actual observation and independent confirmation through procedures involving regular inspection of inventories and confirmation of accounts receivable...."⁸⁷⁰ Price Waterhouse in a swift response retorted that the findings of SEC investigation was unfair because it was supposedly hinged on their failure to test inventory and confirm receivables, procedures not required as audit practice at the time. Moreover, they claimed to have been instructed not to do so by the management. In a statement emitted in their defense, the Price Waterhouse wrote:

While the procedures for whose omission we are now criticized were regarded as optional at the time, we were expressly instructed not to follow some of them, and we were not instructed to follow others, notwithstanding

⁸⁶⁶ ZEFF, S. A., How the U.S. Accounting Profession..., Pt. I, op. cit., p. 192.

⁸⁶⁷ NIEMEIER, C. D., Independent Oversight..., op. cit., p. 3.

⁸⁶⁸ ZEFF, S. A., How the U.S. Accounting Profession..., Pt. I, op. cit., p. 192.

⁸⁶⁹ Id (quoted from The McKesson & Robbins Case, p. 65).

⁸⁷⁰ NIEMEIER, C. D., Independent Oversight..., op. cit., p. 3 and also Accounting Series Release No. 19 (Dec. 5, 1940).

our written warning that the scope of our examinations was not sufficiently extensive “to reveal either possible misappropriations of funds or manipulations of the accounts.” Furthermore, [the SEC report] quite overlooks the fact that the determination of the scope of our audit was delegated to the president of the company, who has now proved to have been the keystone of the intricately organized conspiracy.

To address this lacuna, after the SEC inquiry, the profession expressly began requiring auditors to test inventories and confirm receivables as standard audit procedures. What the profession did not address however, was the seeming reliance by auditors on managements as indicated in this case. Contrary to the earlier assertions of Col. CARTER recounted above, auditors were not an independent check on management, but rather appeared to give management control over the scope of the audit.⁸⁷¹

The years of 1940s to 1960s witnessed the rise of the auditing and accounting profession to the height of its reputation.⁸⁷² Throughout this period, the SEC relied on the accounting profession for generally accepted accounting principles (GAAP) as well as auditing procedures adopted by accounting firms in their engagements. This power and influence enjoyed by the accounting profession in the U.S. was unprecedented. No accounting profession has had such a privilege of setting the norms of professional practice anywhere,⁸⁷³ a sought of *carte blanche* if you will. NIEMEIER argues that although public oversight would not have been a magic wand and may not have solved all financial troubles forever, nonetheless, it might have alleviated some of the worst consequences of the financial scandals.⁸⁷⁴ NIEMEIER’s view is produced here:

To my mind, the SEC’s failure to directly regulate accounting and auditing in those early days contributed to the profession’s difficulties in establishing robust standards that would have provided the basis to challenge management, when necessary. The roots of many of the recent auditing scandals lay in that flawed early policy, including the audits of W.R. Grace,

⁸⁷¹ Id. at p. 4.

⁸⁷² ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 193.

⁸⁷³ Id.

⁸⁷⁴ Id.

Waste Management, Xerox, Enron, WorldCom and others. But even before the scandals of our day, the SEC's policy proved problematic, offering many warning signs that, if heeded earlier, might have spared both the profession and investors many losses.⁸⁷⁵

3.2 FAILURE OF THE AICPA AND THE ADVENT OF PEER REVIEW

The concern expressed above became evident in 1973 with the sudden collapse of Equity Funding, coming on the heels of equally damaging bankruptcy of Stirling Homex a year earlier.⁸⁷⁶ These failures raised questions as to the effectiveness of the standard setting system put in place by the accounting profession. The huge losses suffered by investors, especially, in Equity Funding securities coupled with the discovery of fraudulent dealings, like illegal and improper payments by major corporations that were not reflected in their financial statements, drew the criticism of the Congress on the accounting profession and its private-sector accounting standard setting.⁸⁷⁷

This succession of events prompted an investigation by both the United States House of Representatives and the Senate. Rep. MOSS, Democrat from California, chaired the House subcommittee's investigation of federal regulatory agencies.⁸⁷⁸ In its report, the subcommittee recommended that the SEC take charge of accounting and auditing standard setting and thereby removing this authority from the hands of the private sector.⁸⁷⁹ The Senate on its part undertook a major investigation of the accounting profession by setting up a subcommittee to look into the activities of the accounting profession. The subcommittee was chaired by Sen. MELCALF, Democrat from Montana. The subcommittee launched an extensive factual examination of inter alia, the Big Eight firms, the Institute, and the FASB.⁸⁸⁰ In its final report, *The Accounting Establishment* (1976), the subcommittee came up with groundbreaking as well as controversial recommendations, which OLSON, the Institute's Chief Executive later described as

⁸⁷⁵ Id.

⁸⁷⁶ Both are successful American companies in the 70s that filed for bankruptcy amid allegations of accounting fraud. See ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 200.

⁸⁷⁷ Id.

⁸⁷⁸ Id.

⁸⁷⁹ Id. For more on this report, please see also *Federal Regulation and Regulatory Reform* 1976, 51-53.

⁸⁸⁰ Id.

“almost as damaging to the profession as the Japanese attack on Pearl Harbor was to the U.S. Navy in 1941.”⁸⁸¹

Prominent amongst the conclusions reached by the Senate subcommittee were that the accounting firms lacked independence from their clients and that they dominated the AICPA as well as its process of standard setting.⁸⁸² The study also asserted that the Big Eight accounting firms exercise control over the FASB to advance the interest of their clients.⁸⁸³ The Senate subcommittee in its recommendations followed the footsteps of the House subcommittee by recommending the takeover of accounting and auditing standard setting process of publicly traded corporations by the federal government.⁸⁸⁴ Although these investigations did not end up in legislation, they set in motion a debate that drew national attention to the work of auditors, which put them in a defensive position.⁸⁸⁵

As would be expected, the accounting profession through the medium of the FASB and the AICPA responded to the findings and recommendations of the Senate subcommittee.⁸⁸⁶ In a 40-page booklet tagged *The Institute Responds*, the AICPA countered the arguments advanced by the Senate subcommittee in its report. In response to the charge that accountants compromise their independence by advocating positions favorable to their clients, the Institute affirmed that such did not make them tools in the hands of their clients.⁸⁸⁷ While the FASB, in its 44-page reply stood firm in defense of the independence, integrity and objectivity of its process.⁸⁸⁸ But aside from the posturing, it was dawning on the accounting profession that the negative publicity generated by the investigations of both Houses of Congress had put them on a bad stead with public opinion. In fact it served as impetus for the introduction of self-regulation by the accounting profession.

⁸⁸¹ OLSON, W. E., (1982, p. 43) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 200.

⁸⁸² *Id.* at p. 201.

⁸⁸³ *Id.*

⁸⁸⁴ *Id.*

⁸⁸⁵ *Id.*

⁸⁸⁶ *Id.*

⁸⁸⁷ *Id.* See also *The Institute Responds* .1977, p. 32.

⁸⁸⁸ *Id.*

2.3 ENTER THE SELF-REGULATION PROGRAM

The unwanted publicity coupled with hearings at the United States House of representative and the Senate forced AICPA to rapidly change its methods to avoid public regulation. In fact, a bill proposed by Rep. Moss contemplated a body that in great aspect looked like the Public Company Accounting Oversight Board, now established under the Sarbanes-Oxley Act, 2002. The Institute hurriedly created its Division for the CPA, which consists of the SEC Practice Section (SECPS) and the Private Companies Practice Section.⁸⁸⁹ This move was brilliantly described by GREGORY as follows:⁸⁹⁰

Council created the division for CPA firms without seeking a vote of the membership because it believed that Congress would enact new legislation to regulate the profession if immediate steps were not then taken to bolster the profession's system of self-regulation. That perception was borne out by the introduction by Congressman Moss on June 16, 1978 of H.R. 13175, which provided for a new federal statutory regulatory organization under the oversight of the SEC, to be known as the National Organization of Securities and Exchange Commission Accountancy.⁸⁹¹

The peer review was purposefully established to provide assurance to the public that firms that audited publicly-held companies had effective and quality control systems. Meanwhile, the CPA firms Division was meant to serve as vehicle for self-regulation. The SECPS, on the other hand, was intended to improve the quality and standard of firms that audit companies who filed statements with the SEC.⁸⁹² Since all AICPA members who audited publicly-held companies were required to belong to the SECPS, it was a fundamental prerequisite for membership that they must submit to a mandatory peer review once in every three years.⁸⁹³

⁸⁸⁹ The SECPS section is responsible for firms auditing public companies while latter section is responsible for the firms auditing privately-held companies.

⁸⁹⁰ GREGORY, W. R., was the Institute board chairman from 1979 to 1980.

⁸⁹¹ GREGORY, W. R. (1980, p. 3) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 201.

⁸⁹² ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 201.

⁸⁹³ Id.

In order to boost its public image, the AICPA also constituted a body known as Public Oversight Board (POB), comprising of distinguished public servants that would oversee the activities of the SECPS, including the setting and enforcing of quality control standards and a newly established peer review process.⁸⁹⁴ The POB was funded by the SECPS membership dues. It represented the public, and meet with various elements of the self-regulatory program on a regular basis to give them the public perspective and remind them of public interest they serve.⁸⁹⁵

What then is the peer review program? It is essentially an appraisal of auditors' work based on designated accountants or a firm, named reviewers, carrying out a review of quality control systems, documents, manuals and checklists of another firm being reviewed, called the reviewee.⁸⁹⁶ The reviewers will begin by first acquainting themselves with the firm's quality control policies and procedures. The reviewers then selected a sample of engagements for which the work papers, correspondence files and other documentation were walked through and checked. On the final day, an exit conference is held where the reviewers would explain to the reviewee the scope of their review and any recommendations they may have for improvement.⁸⁹⁷

The SEC, which had long been advocating for the peer review welcomed this development. But unfortunately, the peer review could do little to tame the growing competition among auditing firms for clients that was becoming more intense and vicious by the day. The aggressive pursuit of profit by audit firms in wanton disregard of professional values was more reminiscent of commerce than a profession.

The fierce competition embarked upon by auditors might be because of the changing conditions in the practice of public accounting or may be better attributed to changes in auditors' code of ethics. Auditors like other professionals such as doctors and lawyers are subject to certain professional etiquette usually drawn up by their professional bodies. Part of these professional ethics rules, was the prohibition of direct, uninvited solicitation and competitive bidding. But due to unrelenting pressure from the United

⁸⁹⁴ Id.

⁸⁹⁵ ANANTHARAMAN, D., "How Objective is Peer Review? Evidence from Self-Regulation of the Accounting Profession", *Columbia Business School*, Dec. 4, 2007, p. 7.

⁸⁹⁶ Id.

⁸⁹⁷ Id. at p. 8.

States Department of Justice and the Federal Trade Commission (FTC) in the 1970s over portions of its Code of Professional Ethics alleged to be in restraint of trade, the AICPA was compelled to remove the ban on competitive bidding from its code of ethics.⁸⁹⁸ This amendment together with the unbanning of uninvited solicitation, to the AICPA's code of ethics completely changed the climate in which audit firms conducted their affairs. ANREDER, a close observer of the accounting profession described the situation in an article in *Barron's* as follows:

What's happened, essentially, is that the nation's top accounting firms-some big, some smaller-are locked in a fierce battle marked by vigorous price cutting. Some blame a growth-at-any-cost syndrome they say has afflicted some of the profession's top firms. Others contend that it is an inevitable consequence of a slowing in chargeable hours as the pickings for new clients get slimmer.⁸⁹⁹

With the elimination of bans on activities, such as advertisement, uninvited solicitation and competitive bidding that were previously seen as unethical by the AICPA, auditing became mired in an unrestrained environment of competition for clients, which placed strains on its professional values. This development fundamentally changed accountants' relationship with their clients forever. MASON,⁹⁰⁰ a long critic of the AICPA and the big firms, complained in 1985 about fast erosion of professionalism in the accounting profession as follows:

Today, the media describes public accounting as an industry, seldom as a profession-and it does have all the earmarks of an industry including cut-throat competition, 'low-balling,' cheap advertising, and open solicitation by one CPA of another CPA's clients.⁹⁰¹

Mr. MASON was quick to point the blame at the FTC and the Justice Department for creating what he characterized as "unprofessional and undignified atmosphere."⁹⁰² This disturbing atmosphere of the 1980s as described by BOWMAN, was a sought of rat race

⁸⁹⁸ BIALKIN, K. J., (1987, pp. 105-106) in ANANTHARAMAN, D., How objective is..., op. cit., p. 202.

⁸⁹⁹ ANREDER S. S., (1979, p. 9) in ANANTHARAMAN, D., How objective is..., op. cit., p. 202.

⁹⁰⁰ ELI MASON was a Certified Public Accountant and managing partner of a medium-sized firm in New York City

⁹⁰¹ ELI MASON, (1985, p. 732) in ZEFF, S. A., How the U.S. Accounting Profession..., Pt. I, op. cit., p. 202.

⁹⁰² Id.

where the major accounting firms were pitted against one another in the sharply competitive bidding process.⁹⁰³ He also denounced how companies bid for tenders of between 25 and 50 percent below the previous year's audit fee charged. This situation inevitably leads to one conclusion; auditors were at the receiving end and at the mercy of their clients.

In what may be described as a call for prudence on his professional colleagues, BEECHER, reasoned that, "price competition had always existed between audit firms, but that the firms sold quality as well as price. Clients prized audit quality, before they began to view the audit as a commodity."⁹⁰⁴ The same sentiment was expressed by the architect of the modern firm of Arthur Andersen & Co., SPACEK, while reflecting on accounting values of yesteryears. He wrote:

The competition [today] is in fees only. We always had such competition, but to offset it a firm can strengthen itself by the energetic position it takes to make it a leader... outstanding service is equally an offset, and both characteristics are prime offsets to price. I know because I practiced it for 20 years- saying publicly that we were the highest priced firm, but the higher price was more than matched by quality. Prospective clients seek these qualities to prove they risk the most thorough accounting tests.⁹⁰⁵

Unrestrained competition coupled with the desire to retain valued clients eventually led the big firms to entirely change their posture towards their clients. In previous years, for instance, auditors "conveyed a firm position on the propriety of any borderline accounting and disclosure practices adopted by the client", but during the 1980s auditors would rather find any technical means to go around it or a suitable analogy in order to approve the position sought by their client.⁹⁰⁶ They would be seen huddling with their clients to find ways of compromising rather than standing firm on professional principles. Unsurprisingly, those were the years of consulting known then as Management Advisory Service (MAS).

⁹⁰³ BOWMAN, A. W., (1985, pp. 705-713) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 202.

⁹⁰⁴ Id.

⁹⁰⁵ ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 203. This reflection was made in a letter to ZEFF, S. A. dated Dec. 20, 1984.

⁹⁰⁶ Id.

3. MANAGEMENT ADVISORY SERVICES AND AUDIT PRACTICE

3.1 THE IMPACT OF MAS ON AUDITING SERVICES

As audit accounting continue to transform itself into consulting services, earlier referred to as Management Advisory services, consulting services had become the vogue for accountants, and was fast overtaking the audit services. The reason for this is simple, since a chunk of their revenue came from consulting services, auditing was the means they used to cuddle and appease the client, essentially by foregoing the rigorous requirement of a principled audit. The SEC and other stakeholders have from time to time expressed concern about the apparent conflict of interest the consulting services may suppose for audit practice. A similar concern was expressed by GREGORY when he warned auditors of an increasingly deteriorating professional climate:

It seems that the effects of the phenomenal growth in the profession and the competitive pressure have created in some CPAs attitudes that are increasingly commercial and nearly devoid of the high-principled conduct that we have come to expect of a true professional. It is sad that we seem to have become a breed of highly skilled technicians and businessmen, but have subordinated courtesy, mutual respect, self-restraint, and fairness for a quest for firm growth and a preoccupation with the bottom line.⁹⁰⁷

The SEC tried to find ways to reduce the damage the consulting services may cause the profession by limiting the scope these services. This was reflected in the SEC's 1978 annual report submitted to the Senate's Metcalf subcommittee by the SEC Chairman WILLIAMS as follows:

Another important issue requiring immediate attention is the question of the appropriate range of services—other than the performance of the audit itself—which accounting firms should be permitted to offer to their audit clients...

In considering this issue, it will be necessary to resolve three basic questions:

⁹⁰⁷ Id. This quote is from a speech given by GREGORY, W. R. at the Institute's annual meeting on October 6, 1980.

- a. Are there situations in which the magnitude of the potential fees from management advisory services is so large as to affect adversely an auditor's objectivity in conducting an audit?
- b. Are there some services that are so unrelated to the normal expertise and experience of auditors that it is inconsistent with the concept of being an auditing professional for auditors to perform those services?
- c. Are there, conversely, some services so closely linked to the accounting function that, for the auditor to perform those services for his client means that, the auditor will, in conducting the audit, be in a position of reviewing his own work?

These questions were raised at a critical juncture of audit accounting history, when unprecedented growth and unbridled competition threatened its will to serve the public interest; incidentally the same questions are still being raised today. In a 1979 Release ASR No. 264, "Scope of Services by Independent Accountants", the SEC did not mince words in its warning, which reads as follows:

...the growing array of non audit services offered by some independent public accountants—and the growing importance of management advisory services to the revenues, profits, and competitive position of accounting firms—are a cause for legitimate concern as to the impact of these activities on auditor independence, objectivity, and professionalism.

In a response to the above release, the accounting profession argued that auditors rendering management advisory services to a client actually get to have a better understanding of the client, which helps them in carrying out audit work. The profession concluded that complaints about 'scope of services' was a perception only of those who misunderstood the audit process.⁹⁰⁸ This was, in spite of a 1979 study by the POB on *Scope of Services* by CPA firms, which stated that:

⁹⁰⁸ BURTON J. C., (1980, p. 51) in ZEFF, S. A., How the U.S. Accounting Profession..., Pt. I, op. cit., p. 205.

...there is enough concern about the scope of services in responsible quarters so that the question cannot be dismissed as a “non problem.” The Board believes that there is potential danger to the public interest and to the profession in the unlimited expansion of MAS to audit clients, and some moderating principles and procedures are needed.⁹⁰⁹

This study notwithstanding, the POB was reluctant to take on the profession on the issue, at least, in the second year of its existence. The POB therefore concluded on a reconciliatory note that “at this time no rules should be imposed to prohibit specific services on the grounds that they are or may be incompatible with the profession of public accounting, might impair the image of the profession, or do not involve accounting or auditing related skills.”⁹¹⁰

Meanwhile, the deterioration of audit professional values continued unabated. Many observers feared that on the long run the uncontrolled expansion of auditing to non-audit services will diminish the faith in the auditor’s independence. In a move to find some answers to the issue, the AICPA constituted a committee called *Special Committee on Standards of Professional Conduct for Certified Public Accountants*. The committee was headed by ANDERSON, AICPA Board Chairman 1980-1981. In its interim report, the committee could not sound more alarming:

There has been an erosion of self-restraint, conservatism and adherence to basic professional values at apace and to an extent that is unprecedented in [the] profession’s history... We believe the profession is on the brink of a crisis of confidence in its ability to serve the public interest.⁹¹¹

This Special Committee was appointed in October 1983, and came up with its final report in May 1986. The committee reiterated its observations in the interim that “the competitive environment has placed pressure on the traditional commitment to

⁹⁰⁹ Public Oversight Board (1979, p. 56).

⁹¹⁰ See Public Oversight Board (1979, p. 5) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. I, op. cit., p. 205.

⁹¹¹ Special Committee 1985, pp. 3-4.

professionalism in the practice of public accounting.”⁹¹² The committee however came up with proposals on standards of conduct to “impose a measure of self-restraint and self-regulation by calling upon AICPA members to use their judgment in applying broad standards to determine what is consistent with professional conduct in the provision of non-attest services.”⁹¹³ On the same note, LEE, the AICPA Board Chairman 1983-84 and member of the Special Committee was also quoted as saying:

The profession is changing and change is necessary, but we need to approach it with caution and there needs to be reasonable limitation on what services we should be providing as a profession. There’s a perception by our critics, Congress for one, that we may be sacrificing our objectivity if not our independence. If we do not limit the scope of services, then someone will do it for us.⁹¹⁴

3.2 AUDITING AS MULTIDISCIPLINARY PROFESSIONAL SERVICES

As the world economy expanded in the 1950s and 1960s the demand for audit services became global. Accounting firms pursued aggressive expansion overseas to cater for their globally expanding clients. This expansion included in consulting services as well. Meanwhile, by the 1970s audit firms had apparently come to the conclusion that the audit market was becoming saturated.⁹¹⁵ To remedy this situation, the firms diversified and broadened their consulting services. The expansion in consulting services markedly shifted the distribution of their gross fees from auditing to consulting services. This margin only grew wider in the 1980s to the extent that consulting commanded larger share of their gross fees.

Audit firms like any other profit-seeking enterprises, had always been run as businesses, but unlike other business enterprises they were guided by professional values—their most proud profit. But all this changed in the 1980s. The drive of audit firms became global competitiveness and dominance. To achieve this they must widen the scope and scale of the lucrative consulting services, develop strategic plans to promote growth and

⁹¹² See *Restructuring Professional Standards*, (1986, p. 6) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 268.

⁹¹³ *Id.*

⁹¹⁴ WEINSTEIN, G. W. (1987, p. 50) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 268.

⁹¹⁵ ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 270.

global reach and of course greater profitability.⁹¹⁶ What they achieved in the end was transformation into worldwide enterprises, serving multinational clients around the globe in services across the board. This is evident in the global dominance of the audit market by the so-called Big Four.

One important factor that adds credence to the fact that audit firms had abandoned their professional aims in their quest for profitability was the pressure they placed on partners to reach certain “income targets.” Partners must strive to attain these targets or face the consequences, which may include dismissal from the firm, in extreme cases. This business strategy was by no means empowering nor was it compatible with a partner having the necessary confidence to stand up to clients on questionable accounting practices. WALTERS argued that in their push for profitability the big firms were reluctant to lose any client even on principle.⁹¹⁷

The practice of dismissing underperforming partners is not novel to auditing, but it was usually on grounds of non-adherence to professional standards, not because of failure to bring more business to the firm. This fearsome competitive atmosphere in the practice of public accounting was well captured by COOK when he observed in 1985 that: “Five years ago if a client of another firm came to me and complained about service, I’d immediately warn the other firm’s executive...Today I try to take away his client.”⁹¹⁸ In the heat of the pursuit of profitability Peat Marwick and Thornton & Co. were reported in 1985 to have dismissed some partners for their failure to meet marketing targets.⁹¹⁹ On this altered professional to business mindset, WALTERS in 1985 was quoted to have observed that:

The major firms are on growth treadmill that inevitably will stop, but each manager is determined to keep it moving even faster during his regime. This has required diversification into many “information based” services. The aggregate effect of these diversifications is to change the balance of the professional mindset—moving farther from an audit mentality and toward a consulting mentality. The diversified service draws the firms increasingly into competition

⁹¹⁶ Id. at p. 271.

⁹¹⁷ WALTERS, R. (1984) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 271.

⁹¹⁸ BERTON, L. (1985, p. 1) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit., p. 272.

⁹¹⁹ Id.

with other disciplines that have few or no professional/competitive constraints, and our traditional professional standards of conduct are a competitive handicap.⁹²⁰

With the apologist mindset adopted by the audit firms, mainly to appease their clients instead of standing up to them, it was just a matter of time before something goes wrong. Sooner than later it happened.

When many banks and savings institutions began to file for bankruptcy in 1980s, questions were raised about the propriety of auditing and accounting practices.⁹²¹ Moreover, auditor fraud allegations in high profile cases like E.S.M. Government Securities, Wedtech Corp. and ZZZZ Best embarrassed the accounting profession.⁹²² These cases, nevertheless, did not make things better instead things took a turn for the worse, because regulators of banks and the thrift institutions encouraged the use of deceptive accounting practices to “rescue” these institutions because of “public interest.”⁹²³ The AICPA was also reported to have joined the regulators in pleading with the FASB to be responsive to the problems of the industry.⁹²⁴

What followed thereafter was the accounting profession raising the ante. Moreover, with the help of a new regulation, Regulatory Accounting Practices (RAP), that allowed banks to ignore losses they sustained on bad loans or amortize the losses for a period of five to ten years, in clear violation of GAAP.⁹²⁵ Almost at the same time, companies CEOs were under enormous pressure to achieve forecasted earning targets, the CEOs will usually turn to companies’ accountants to help them “manage” to achieve these targets. Auditors would subsequently be asked to do whatever they can to approve these accounts. This was referred to as “creative accounting technique.”⁹²⁶ In other words auditing had become the means of looking for loopholes in regulation or whatever is necessary to validate client’s accounts.

⁹²⁰ WALTERS, R., a partner in Touch Ross was writing to ZEFF, S. A., in a letter dated February 1, 1985.

⁹²¹ ZEFF, S. A., How the U.S. Accounting Profession..., Pt. II, op. cit. p. 272.

⁹²² Id.

⁹²³ BERTON L., (1985, p. 1) in ZEFF, S. A., How the U.S. Accounting Profession..., Pt. II, op. cit. p. 273.

⁹²⁴ Id.

⁹²⁵ The regulatory accounting practices regulation was actually contrary to GAAP.

⁹²⁶ ZEFF, S. A., How the U.S. Accounting Profession..., Pt. II, op. cit. p. 273.

As this trend continued, the SEC had so far avoided confrontation with the accounting profession. It nonetheless strongly disagreed with the profession that independence should be judged “from the perspective of a reasonable and prudent person who possesses both knowledge and experience.”⁹²⁷ The SEC emphasized that independence should be judged from the perspective of a “reasonable investor” and the “investing Public.”⁹²⁸

Meanwhile the profit mentality of the profession continued unabated. STEVENS in his 1991 book made this resounding warning on the future choices that await the profession:

As the firms become more intimately involved with their clients through their consulting practices, as they think of themselves more and more as consultants who happen to do audits just to get a foot in the door and as they continue to reward salesmanship and marketing over technical proficiency, they are clearly headed toward a day of reckoning—a day when the firms, or Congress acting for them, will force the issue and demand that they decide whether they want to retain the licensed privilege of auditing the corporate community by spinning off the MAS practices, or whether they want to join in the open competition of management consulting by ejecting the audit practice.⁹²⁹

As increasing number of non-audit personnel who are not bound by the Code of Ethics of the profession continue to climb their firms’ ladder of leadership, the SEC voiced out its concern to the audit profession on the consequences of this development on credibility of auditing.⁹³⁰ Meanwhile in its 1993 report, the POB adverted to the growing public concern on the performance of the audit profession and recommended that auditors should take necessary steps to reassure the public of their objectivity and independence.⁹³¹

⁹²⁷ Id. at p. 275. This definition of reasonable person seems to favor accountants’ point of view but as the SEC understands everybody cannot be an accountant, hence reasonability should remain objective.

⁹²⁸ Id.

⁹²⁹ STEVENS, M. (1991, pp. 250-251) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 276.

⁹³⁰ Id.

⁹³¹ Public Oversight Board (1993, pp. 43-46) in ZEFF, S. A., *How the U.S. Accounting Profession...*, Pt. II, op. cit. p. 276.

By the second half of the 1990s market consulting and non-audit services intensified. Arthur Anderson for example created Anderson Consulting. Their only concern was threat of litigation. To cast away this threat, the big firms together with the AICPA lobbied the US Congress to overturn President Clinton's veto and approve the Private Securities Litigation Reform Act of 1995.⁹³² With threat of litigation at bay, auditors felt safer and took more risks by broadening the scope of their consulting services with new services like "assurance services",⁹³³ and attestation, which according to ZEFF implies retrospective auditing.⁹³⁴ The cumulative effect of this was that it created a climate of insecurity for the audit partners to resist applying the sometimes illicit accounting interpretation of their client or risk jeopardizing their chief source of income. This atmosphere was best summarized by the Public Oversight Board's Panel on Audit Effectiveness as follows:

The growth in equity value over the past decade has introduced extreme pressure on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet "street" expectations. Pressures are further magnified because management's compensation often is based in large part on achievement earnings or other financial goals or stock-prices increases. These pressures on management, in turn, translate into pressures on how auditors conduct audits and their relationship with the client.⁹³⁵

Indeed the financial crisis could not find a more fertile ground to happen; shame of a profession that had gained the world at the expense of its soul. ZEFF described it as a recipe for disaster.⁹³⁶ Perhaps that disaster was the financial crisis.

⁹³² This law effectively ended joint-and-several liability claim against auditors because it required that plaintiffs must present evidence of fraud before any pretrial is allowed and fraud is very difficult to prove.

⁹³³ Id. at p. 278. Meanwhile, ELLIOTT, R., (1995, p. 29), has defined *assurance services* as "services that improve the quality of information or its context for decision makers through the application of independent professional judgment." Id.

⁹³⁴ Id.

⁹³⁵ The Panel on Audit Effectiveness 2000, pp. 2-3 cited from ZEFF, S. A., How the U.S. Accounting Profession..., Pt. II, op. cit. p. 279.

⁹³⁶ Id.

4. EUROPE: FROM NATIONAL TO ‘FEDERAL’ AUDIT FRAMEWORK

As seen above, although Europe may have a shared history with US in the evolution of auditing to what it is today, their respective regulatory framework grew on a different footing. Whereas, the US audit developed within a relatively unified regulatory and legal environment, audit regulation in the EU developed heterogeneously at national levels. Although audit regulation in both the EU and the US are established for the same purpose: to protect the users of financial statements, both had threaded different paths to achieve that aim. When regulation is discussed in Continental Europe, for example, this typically means public supervision.⁹³⁷ The US on the other hand had a long history of peer review mechanism until very recently.

Since the individual countries of Europe pursued audit regulation through their national laws, it means that variations in the national regulations may translate into differences in the quality of audit, which makes a single audit market a farfetched idea. All the same, under the Fourth Council Directive 78/660/EEC, the EU continued to use the existing national legislations by recommending that companies covered by the Directive “must have their annual accounts audited by one or more persons authorized by national law to audit accounts.”⁹³⁸ This requirement was later extended by the Seventh Council Directive 83/349/EEC on companies producing consolidated financial statements.⁹³⁹

After observing that divergent external quality assurance is inimical to the single market goals, the EU through the Eighth Directive 84/253/EEC prescribed common standards for approval of persons undertaking statutory audits. This inter alia, included minimum educational qualifications and/or practical experience required of auditors. The Directive, however, “stops short of including requirements as to how an audit should be performed.”⁹⁴⁰ Obviously, a single audit market cannot thrive on divergent ways of conducting audits. To tackle this problem, a number of issues have to be resolved by the EU. These issues are, first, “the extent to which auditing practices are standardized across the EU to ensure that financial statements of companies in member states are

⁹³⁷ FERRARINI, G & GIUDICI, P., *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI Working Paper Series in Law, N° 40, 2005, p. 3.

⁹³⁸ Fourth Directive, Article 51.1(a).

⁹³⁹ DEWING, I. P. & RUSSELL, P. O., *Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Developments Before and After Enron*, Blackwell Publishing Ltd., JCMS, 42, 2004, p. 295.

⁹⁴⁰ Id. at p. 296.

underpinned by common levels of assurance and credibility.”⁹⁴¹ The second is the issue of audit expectation gap, seen in Chapter III as responsible for some high-profile corporate failures in the EU as well as around the world. These “failures invite rigorous scrutiny of the role and independence of the statutory auditor, which invariably leads to calls for reform.”⁹⁴² The third, according to DEWING & RUSSEL “is the extent to which there is a European market in audit services, as differences remain in laws and regulations” among member states. In fact the countries that constitute the single market do not mutually recognize the qualifications of their professionals.⁹⁴³

The EC, with all the symptoms of a federation, albeit in denial, realized that no single market can endure with this incompatibility. To unearth the problems, the EC promoted some studies, such as the study on “Competition in European accounting” (1992) and on the “Role, the Position and the Liability of the Statutory Auditor” (1996).⁹⁴⁴ The studies indeed showed that so long as the important differences between the national laws and regulation of member states remain, there cannot be a European market in audit services. This is succinctly summed up in the published Green Paper⁹⁴⁵ as follows:

The role of the statutory auditor has recently been the subject of much debate worldwide. As a result in particular of a number of important financial failures, questions have been raised concerning the function of the statutory audit and the independence of the auditor. At EU level, it has been difficult to respond to these questions because the regulatory framework which surrounds the statutory audit at EU level is incomplete. There is no common view at EU level on the role, the position and the liability of the statutory auditor. The absence of such a common view has a negative impact on audit quality and on the freedom of establishment and freedom to provide services in the audit field.⁹⁴⁶

⁹⁴¹ Id.

⁹⁴² Id.

⁹⁴³ Id.

⁹⁴⁴ FERREIRA-GOMES, J. J. M., “Auditors as Gatekeepers: The European Reform of Auditors’ Legal Regime and the American Influence”, *Colombian Journal of European Law*, 11, 2005, p. 672.

⁹⁴⁵ Green Paper on the Role, the Position and the Liability of the Statutory Auditor within the European Union, European Commission, 1996, accessed June 5, 2010 at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/700996 en pdf [hereinafter “Green Paper”].

⁹⁴⁶ Green Paper, par 1.2.

The document after analyzing and discussing the “existing regulation of the statutory audit at EU level and the reasons why renewed action at EU level may be justified” came to the following priorities for action, which among others are that:

- a. The absence of a common definition of the statutory audit in the EU creates a damaging expectation gap. A common approach to the statutory audit, taking account of the latest developments at international level, seems desirable. If the audit is to add confidence to published financial statements, users need to know what the audit certificate means in terms of assurance. In this regard, particular attention should go to the role of the auditor in respect of the going concern status of the company and the action to be undertaken by the auditor in case of fraud and other illegal acts.
- b. Consideration should be given to what extent existing International Standards on Auditing could be the starting point of a common definition of the statutory audit. Full account would also need to be taken, however of any particularities which distinguish the European from the international environment.
- c. To be effective, the common definition would need to become part of the regulatory framework in all Member States. It is for consideration whether an EU Directive would be needed to achieve this result or whether a Recommendation would suffice. In either case, due attention would need to be paid to flexibility, so that any legal requirement can easily be adapted to the rapidly changing environment in which the auditor operates.
- d. Once an agreement has been reached on the definition of the statutory audit, it should be easier to agree on the minimum content of the audit report. Because the audit report is the medium through which the statutory auditor communicates with shareholders, creditors, employees and with the public at large, it seems desirable that a similar wording in the audit report is used throughout the EU.
- e. In several member states the wording of the audit report has been adapted to that developed by the International Federation of Accountants. It is for consideration to what extent this could also be the starting basis for a common definition at EU

level. Proper attention would however need to be given to any particularities which distinguish the European from the international environment. In order to reduce the expectation gap, it would be necessary for the audit report to provide more information on what the auditor has actually done, which professional standards he has applied in carrying out his task and whether the financial information prepared by the company conforms with legal and other regulatory requirements. It would also be necessary for any reservations which the auditor might have to be clearly spelled out in his report.

- f. As for the definition of the statutory audit, it seems necessary for the common definition of the audit report to have legislative backing in the Member States. It is for consideration whether this points to binding legislation (i.e. a Directive) at the EU level, or whether a Commission Recommendation would be enough. Due attention must in any case be paid to flexibility, so that any legal requirement could be easily adapted to the rapidly changing environment in which the auditor operates, in particular developments related to the introduction of new information technologies.
- g. It is for consideration which instrument is most appropriate to ensure that an agreement reached at EU level is likely to be adhered to in practice.
- h. Recent debates about corporate governance have stressed the need to define more clearly the role of the board of directors in preparing the financial statements. The issue is however much more complicated and extends to defining the role of all parties involved in the financial reporting process (board of directors, supervisory board, general meeting of shareholders, auditor). In order to improve the system of checks and balances within the company, more attention should be paid to issues such as the creation of an audit committee and the establishment of a proper functioning system of internal control.
- i. It is difficult to deal at EU level with matters of corporate governance: past efforts to harmonize law on the structure of the company have not succeeded. In order to contribute to the debate at national level, it might be useful to consider a Recommendation at EU level on possible ways to improve the present system of

corporate governance, especially in as far as it relates to financial reporting. It would then be up to member states to initiate any necessary legislative action at national level.

- j. The absence of a legal requirement at EU level that all statutory audits conducted on the basis of Community law must be carried out on the basis of an agreed set of auditing standards is a handicap for the Single Market and in the international context. It should be examined whether the standards on auditing developed by the International Auditing Practices Committee of the International Federation of Accountants and already applied to a certain extent in most member states could provide a possible basis for agreed standards at EU level. As with international accounting standards, it would seem necessary to devise a mechanism to determine whether existing IFAC standards meet European requirements and to ensure increased European influence in the development of international auditing standards.
- k. Such a mechanism at EU level could bring together all parties involved at national level in the definition of auditing standards and could discuss all relevant auditing matters. It would be important that an assurance be obtained that any auditing standards agreed upon at EU level were actually being followed in practice at national level. This might be difficult to achieve without giving those standards some kind of legal backing.
- l. Even if a code of principles on auditor independence and a core set of auditing standards can be agreed upon, the system will only be effective if the standards are enforced and if there is appropriate quality control. If a mechanism were set up at EU level, as suggested above, one of its tasks could also consist in examining the way in which quality control in the audit field is assured in the various Member States. Within the context of the Single Market, it is also important that the regulatory authorities in member states communicate with each other. The rules of professional secrecy should not present any obstacle to this.⁹⁴⁷

⁹⁴⁷ Id par. 3.36-47.

This was followed by further consultations and conference⁹⁴⁸ to discuss the issues raised in the Green Paper. The Green Paper quickly got the support of Economic and Social Committee,⁹⁴⁹ which urged the Commission to establish priorities and an action plan setting forth minimum requirements for the European Union. The European Parliament followed suit by adopting the Green Paper in its resolution of January 15, 1998. The Parliament further emphasized the importance of auditor independence requirements and urged for a new legislation on the issue.

Based on the results of the studies promoted and the comments received, the EC issued a communication on “The Statutory Audit in the European Union: The Way Forward.”⁹⁵⁰ This communication proposed setting up of a committee on auditing composed of experts nominated by Member States, representatives of the bodies responsible for elaborating auditing standards at national levels and representatives of national and European accounting and auditing profession. The committee is charged with the following task with emphasis on self-regulation:

- A. a review of existing international standards on auditing and their application in an EU context with the objective of determining whether the application of these standards meets the full need for auditing standards in the EU or whether there are gaps to be filled,
- B. contributing to the work of the International Auditing Practices Committee of the International Federation of Accountants, including coordination of views on exposure drafts,
- C. an examination of the audit quality monitoring systems in the member states and of possible proposals for improvement,

⁹⁴⁸ Conference on The Role, the Position and the Liability of the Statutory Auditor within the European Union, Brussels, December 5 and 6, 1996. See the corresponding Act available at the website of the European Commission, http://europa.eu.int/comm/internal_market/en/company/audit/docs/acten.pdf.

⁹⁴⁹ This communiqué was adopted on February 26, 1997.

⁹⁵⁰ Commission Communication on the Statutory Audit in the European Union: The Way Forward, May 08, 1998, 1998 OJ C 143 [hereinafter “Commission Communication, 1998”]

- D. an examination of a set of core principles on independence developed by the European accounting profession.

Further recommendations of the communication included: that audit should be seen in the wider context of corporate governance, and therefore the position of the auditor within the company must be strengthened; the professional liability of auditors should also be examined; and that more effort should be exerted to ensure that member states mutually recognize each other's auditors.⁹⁵¹

After some fault starts, like the failure of the Proposed Fifth Directive (1972–1988), the EU managed to get its initiatives on audit quality assurance back on track with publication of two recommendations.⁹⁵² The first being, the Commission Recommendation 2001/256/EC, of November 15, 2000, on quality assurance for the statutory audit in the European Union: minimum requirements. In this document, the Commission sets out a benchmark for member states on their quality assurance systems by recommending common minimum requirements, as shown below:

1. Member States should have a minimum standard of assurance on financial statements reliability;
2. Both peer review and monitoring (where peers carry out quality assurance review and where employees of professional body or regulators do so) are acceptable methods for quality assurance;
3. All auditors should be consistently reviewed over a maximum period of six years except those auditing 'public interest entities' and auditors with less than satisfactory review results;
4. The scope of quality should include an assessment of the internal quality control system of an audit firm;

⁹⁵¹ Commission Communication, 1998

⁹⁵² FERREIRA-GOMES, J. J. M., Auditors as Gatekeepers..., op. cit., p. 673.

5. Quality assurance systems should have adequate public oversight consisting of a majority of non-practitioners on the overview board, and should also publish its results;
6. Member states should have a disciplinary mechanism with power to sanction auditors, including their removal from the statutory auditor's registry;
7. Audit files that are subject to review for the purpose of quality assurance should be exempted from confidentiality clauses, nonetheless, reviewers must comply with the same confidentiality standards required of auditors;
8. Finally, member states should ensure that reviewers have necessary resources to be objective and independent.

The second recommendation was the Commission's Recommendation 2002/590/EC, of May 16, 2002, on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles. As the name suggests, it sets out some fundamental principles and specific requirements regarding the independence of auditors in member states of the EU. It went on to emphasize that the responsibility of upholding the principles of independence lies first and foremost on the auditor. Hence, auditors must desist from carrying out an audit "if there are any financial, business, employment or other relationships between the statutory auditor and his client (including certain non-audit services provided to the audit client) that a reasonable and informed third party would conclude compromise the statutory auditors independence."⁹⁵³ These fundamental principles were inter alia that:

- a. Auditors must be and be seen to be credible, independent and objective in carrying out their functions;
- b. Auditors have the responsibility to ensure that the principles of independence are upheld in the course of their duty;

⁹⁵³ Id.

- c. Circumstances that pose threat to auditor's independence must be identified and avoided. The nature of these threats according to the recommendation include, self-interest, self-review, advocacy, familiarity or trust and intimidation;
- d. Where there may be threat to independence, adequate safeguard measures should be put in place to mitigate or eliminate the threat;
- e. Auditors should undertake individual policies on independence which must be flexible to accommodate future changes;
- f. Auditors should be transparent on the fees they charge on auditing as well as non-auditing services.

Audit regulation in Europe continue to develop within the single market, albeit, at a slow pace until the financial scandals struck. The EU, according to DEWING, had prior to the financial scandals abandoned its approach of issuing company law directives as evidenced in the EC communication (EC, 2003b) on statutory audit,⁹⁵⁴ where the EC signaled its preference to International Standards (ISAs) on Accounting prepared by the International Auditing and Assurance Standards Board (IAASB). The EU felt more at home with international standards like the ISAs and was keen to encourage their mutual recognition on both sides of the Atlantic, perhaps for the fear of global dominance of American standards.⁹⁵⁵

⁹⁵⁴ This communication is discussed below under Europe's response to Enron.

⁹⁵⁵ DEWING, I. P. & RUSSELL, P. O., *Accounting, Auditing...*, op. cit., p. 298.

5. ENRON AND THE GLOBAL FINANCIAL CRISIS

5.1 THE INCEPTION OF THE CRISIS

Right at the beginning of the new millennium a wave of corporate and financial scandals gripped the US financial market. But what caught the most public attention was that of the Enron, considered to be the largest bankruptcy in US history.⁹⁵⁶ The circumstances of Enron's fall should be analyzed in a wider context of its abrupt rise to fame. As the saying goes, hasty climbers have sudden falls. The Enron fairy tale began as a response to a lot of debt it incurred in the course of the merger process and made worse by deregulation in the sector which broke the exclusive rights it had to its pipelines.⁹⁵⁷ The company had to find a new and innovative ways to make profit and keep its cash flow, if it wants to survive.

The company assigned this task to Jeffrey SKILLING, a young consultant with a background in banking and asset and liability management. The young consultant came up with a revolutionary solution to Enron's problems cash flow and profit.⁹⁵⁸ SKILLING proposed the creation of a "gas bank" in which Enron would buy gas from a network of suppliers and sell it to a network of consumers.⁹⁵⁹ This way Enron would control and guarantee both the supply and the price, thereby charging fees for the transactions and assuming the associated risks. Through the guidance of the young consultant, the company returned to profit as well as created both a new product and a new paradigm for the industry, called the energy derivative.⁹⁶⁰

The company was so impressed by SKILLING's genius that it created a new division called Enron Finance Corp to be headed by Skilling. Under SKILLING's watch Enron dominated the market for natural gas, with more contacts, more access to supplies and more customers than any of its competitors. With its market power, Enron could predict future prices with great accuracy, thereby guaranteeing superior profits. As a result,

⁹⁵⁶ Enron was born as a result of a merger between Houston Natural Gas and InterNorth, a Nebraska Pipeline Company in 1985. InterNorth, according to Wikipedia, was a major business for natural gas production, transmission and marketing as well as for natural gas liquids and was an innovator in the plastics industry. See http://en.wikipedia.org/wiki/Enron#Early_history, accessed March 10, 2014.

⁹⁵⁷ WILLIAM, T. C., "The Rise and Fall of Enron", *Journal of Accountancy*, April, 2002, p. 1.

⁹⁵⁸ Id.

⁹⁵⁹ Id at p. 2

⁹⁶⁰ Id.

Enron parts from a comparatively advantaged position in relation to its close competitors, as Skilling puts it:

If you look at this whole concept of creating markets, the fundamental advantage of a virtually integrated system vs. a physically integrated system is you need less capital to provide the same reliability. How do you do that? It's a financial theory. Non delivery is a nonsystematic risk. If a pipeline blows up or a compressor goes down or a wire breaks, the bigger your portfolio, the greater your ability to wire around that....So, if for example, I'm just starting in the gas merchant business and I'm selling gas from central Kansas to Kansas City, if the pipeline [between those places] blows up, I'm out of business. For Enron, if that pipeline blows up, I'll back haul out of New York, or I'll bring Canadian gas in and spin it through some storage facilities. If you can diversify your infrastructure, you can reduce nonsystematic risk, which says there's a...very strong tangible network effect.... But you've got to get big, you've got to get that initial market share, or you're toast. That's why we'll continue to see shakeouts in this business. It's impossible to manage risk if you're a little player.⁹⁶¹

Enron, like many other companies, took advantage of US accounting rules, which allows the use of “special purpose entities” (SPEs) to access capital and manage assets off balance sheet. These accounting rules were measures companies were allowed to use in order to spread their risk.⁹⁶² Through the use SPEs return on an asset (ROA) can be

⁹⁶¹ BRATTON, W. W., “Enron and the Dark Side of Shareholder Value”, *Faculty Scholarship*, Paper 844, 2002, p. 1289, accessed March 8, 2013 at http://scholarship.law.upenn.edu/faculty_scholarship/844. See the totality of the interview on Online Extra: Q & A with Enron's Skilling, Bus. WK. ONLINE, accessed on June 15, 2012 at http://www.businessweek.con112001/01_07/b371901O.htm.

⁹⁶² The use of the SPEs was by no means a standard accounting practice. It was a novelty introduced in the 1990s to help companies spread their risks. In this sense, DEAKIN & KONZELMANN in DEAKIN, S. & KONZELMANN, S. J., *Learning from Enron*, ESRC Centre for Business Research, Cambridge, Working Paper No. 274, p. 5 argue as follows:

It is a basic principle of modern company law and accounting practice that the accounts of parent and subsidiary companies in the same group should be consolidated. Otherwise, it is a fairly simple matter to shift assets between parent and subsidiary in such a way as to give a misleading impression to shareholders of the state of their respective balance sheets. This principle has been recognized for over half a century in developed economies and was introduced as a response to some of the more egregious accounting scandals that accompanied the Great Crash of 1929 and the economic depression of the 1930s. Id.

maximized, and risk minimized, by transferring it to an SPE, which must at some point repay the debt that it has incurred to the vendor company. An outside investor comes in to supply external capital and share the risk with the vendor, in exchange for which it also gets to share in the high rate of return that the SPE can provide. Albeit, the Financial Accounting Standards Board (FASB) guidelines requires that only 3% of the SPE be owned by an outside investor.⁹⁶³ Otherwise such SPE must be classified as a subsidiary and its financial position declared in the company's financial statements.

Under the leadership of Andrew FASTOW, Enron embarked on a complex and sophisticated financial engineering that overstretched the limits of accounting rules and took the use of SPEs to new heights.⁹⁶⁴ Typically, Enron SPEs, with the acquiescence of major banks, would borrow money often with guarantees from Enron. The borrowed cash would then be used to bolster Enron finances, but was not necessarily transferred to Enron. The debt is not reflected on its financial reports and Enron did not disclose the contingent liability for the debt as required by GAAP.⁹⁶⁵ Other dubious method encouraged by FASTOW was the transfer of losses of investment companies owned by Enron to the SPEs in order to avoid reporting those losses in Enron's financial report. Often failed investments are sold to these SPEs at inflated prices and the cash payment by the SPEs is then used to transfer borrowed money as cash flow from sale of investments.⁹⁶⁶ In addition, one unit of Enron would sell energy to a SPE that would then resell it to another Enron unit. The SPE would borrow money to pay for the energy. Then the cash would be subsequently transferred to the selling unit of Enron as an increase in revenues. Through these various methods, Enron manipulated its finances to reflect positive cash flow from its operations.⁹⁶⁷

⁹⁶³ The three percent test is a SEC accounting rule. It originated in a 1991 letter of the Chief Accountant of the SEC issued in respect of a leasing transaction. The GAAP authorities are Emerging Issue Task Force (EITF) Topic D-14: Transactions Involving Special Purpose Entities; EITF 90-15: Impact of Non substantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions; EITF Issue 96-21: Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities. Id

⁹⁶⁴ ANDREW FASTOW was a young Kellogg MBA banker with experience of working on leveraged buyouts and other complicated deals at Continental Illinois Bank in Chicago. FASTOW was a star hire and protégé of Skilling who swiftly moved through the ranks and became Enron's chief financial officer in 1998. FASTOW had the reputation of being a financial wizard credited with constructing the notorious and complex financial vehicles that drove Enron's growth. WILLIAM, T. C., *The Rise...*, op. cit., p. 2.

⁹⁶⁵ CUNNINGHAM, G. M. & HARRIS, J. E., "Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A", *Global Perspectives on Accounting Education* 3, 2006, p. 41.

⁹⁶⁶ WILLIAM, T. C., *The Rise...*, op. cit., p. 3.

⁹⁶⁷ CUNNINGHAM, G. M. & HARRIS, J. E., *Enron and Arthur Andersen...*, op. cit., p. 42.

As Enron's fortunes rose, in particular during the second half of the 1990s, Enron was celebrated in the financial press and in business schools as a case study and it was seen as an embodiment of an agenda for the modernization of corporations into the 21st Century.⁹⁶⁸ This perception was all Enron needed. As a result Enron's share prices enjoy enormous growth as it was seen as a low-risk option by investors. Enron rode on the wave of success of the U.S. economy during the 1990s, perhaps the longest bull market in the history of the country. However, from early 2000 as the result of the bursting of the dotcom bubble, Enron's shares took a dive and began a free fall. There was little or nothing Enron could do about this. But as the share price steadily declined through the spring and summer of 2001, it looked increasingly likely that its SPEs would default on their obligations to Enron.⁹⁶⁹ DEAKIN & KONZELMANN argue that Enron made matters worse, when it made no attempt to "take out a separate 'hedge' on the deals in question by transacting for a third party to take the risk of default. Essentially this was because the assets concerned (the Rhythms stock and similar financial investments) were simply too 'large and illiquid' (in effect, too risk-prone) to be hedged in the normal way."⁹⁷⁰

The fall of Enron was spectacular in its depth and its global consequences. Enron's collapse came to be known as the largest and most significant corporate failure to grip the United States and perhaps the industrial world in recent memory. But it was only one in a series of clients failures suffered by Andersen, one of the biggest five auditing firms of its days.⁹⁷¹ According to DRAKE "Enron hurtled towards bankruptcy in a matter of months: three months before its demise, the seventh largest company in the US stood \$62.8 billion strong on paper. The Enron share price plummeted from \$75 to 72c in less than a year, after Enron eventually admitted to overstating its profits by \$586 million since 1994."⁹⁷²

⁹⁶⁸ DEAKIN, S. & KONZELMANN, S. J., *Learning from Enron*, op cit., p. 1.

⁹⁶⁹ Id at p. 7.

⁹⁷⁰ Id. See also POWERS, W., TROUBH, R. & WINOKUR, H., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, Counsel: Wilmer, Cutler & Pickering. Houston, Texas, 2002, p. 100.

⁹⁷¹ WILLIAM, T. C., *The Rise...*, op. cit., p. 6.

⁹⁷² DRAKE, H., *The Legal Regulation...*, op. cit., p. 9. See also VINTEN, G., "The corporate governance lessons of Enron", *Corporate Governance: The international journal of business in society*, 2, 2002, pp. 4-9.

The severity of Enron's collapse and the scope of previously hidden losses discovered sent shockwaves through the global corporate community. Approximately 11,000 employees lost both their livelihood and their pension, as the Enron employee pension fund constituted 62% of Enron's total shares, all of which was now rendered completely worthless.⁹⁷³ An unsuccessful attempted merger with Enron's smaller energy competitor, Dynegy, signaled the end of an era: On the first of December 2001, Enron finally filed for bankruptcy protection.

As the external auditor of the company since its inception,⁹⁷⁴ Andersen was the Enron's only external auditor for sixteen years. Andersen implemented a newly designed "integrated audit" package that combined a wide array of audit and non-audit services: this package left Andersen in charge of the whole internal audit function since 1994, after securing a lucrative five-year contract with Enron worth \$18 million. The integrated audit package also included business and legal advice.⁹⁷⁵ As Enron employees themselves were previously in charge of the internal auditing function before the task was outsourced to Andersen, the whole Enron internal audit team was promptly hired by the external auditor. Andersen employees even set up their office inside Enron's Houston building. The overly close relationship between Enron and Andersen staff was strengthened by the fact that many ex-Andersen employees were snapped up by Enron and consequently, Andersen auditors were auditing the work of ex-colleagues. Andersen was doing its utmost to appease its largest and most profitable client in Texas.⁹⁷⁶

Andersen's Professional Standards Group, an internal committee of experts that determined the accounting protocol to be followed by all Andersen staff, frequently questioned the methods used by the Andersen staff on the Enron audit, only to cave under pressure from their client. Enron continued to increase pressure on Andersen to approve the use of "creative and aggressive"⁹⁷⁷ accounting methods and even "intelligent gambling" with revenue figures and off-balance sheet transactions,⁹⁷⁸

⁹⁷³ BBC News Online "*Enron: Timeline*" BBC (2007-12-16)

⁹⁷⁴ DRAKE, H., *The Legal Regulation...*, op. cit., p. 10.

⁹⁷⁵ Id.

⁹⁷⁶ Id.

⁹⁷⁷ Id. See also OPPEL JR., R. A. & EICHENWALD, K., "Enron's Collapse: The Overview; Arthur Andersen Fires an Executive for Enron Orders", NYT, January 16, 2002

⁹⁷⁸ DEAKIN, S. & KONZELMANN, S. J., *Learning from Enron*, op cit., p. 5.

eventually, resulted in the dismissal of a member of the Professional Standards Group who repeatedly objected to Enron's proposed accounting methods.⁹⁷⁹

The amount of influence that Enron exercised over its auditor is directly in contrast to the principle of independence. As word spread that the SEC would launch an investigation into Enron's spectacular third quarter losses, the audit partner in charge of the Enron audit ordered the mass shredding of Enron paperwork and deletion of electronic records.⁹⁸⁰ The shredding only stopped more than two weeks and approximately 30,000 computer files and emails later on November 8, 2001, pursuant to the issue of a subpoena against Andersen.⁹⁸¹ It was this mass erasure that resulted in the obstruction of justice charge, the indictment alleging that Andersen had "knowingly, intentionally and corruptly persuade[d] and attempt[ed] to persuade other persons, to withhold and... alter, destroy, mutilate and conceal objects with [the] intent to impair the objects' integrity and availability for use in such official proceedings".⁹⁸²

Andersen was subsequently found guilty on the charge of obstruction of justice, and ceased auditing public companies by August 31, 2002 due to pressure from the authorities to give up its auditing license.⁹⁸³ On May 31, 2005, the Supreme Court unanimously overturned the Andersen conviction, citing that the jury instructions "failed to convey the requisite consciousness of wrongdoing", which left the scope to determine intent too wide. This technicality, although saving Andersen some dignity, did not allow the defunct auditor a re-entry into the auditing industry.⁹⁸⁴ All of Andersen's clients moved on to rival auditors leaving only a few employees at the

⁹⁷⁹ HOUSWORTH, G., "Enron and Arthur Andersen: To Comply is Not Enough" *CriticalEye*, 2002, p. 23.

⁹⁸⁰ OPPEL JR., R. A. & EICHENWALD, K., *Enron's Collapse...*, supra. They wrote that "Arthur Andersen fired its partner in charge of auditing the Enron Corporation today, saying he had ordered the destruction of thousands of documents and e-mail messages after learning that the Securities and Exchange Commission had begun an investigation of Enron's accounting....The fired partner, David B. Duncan, called a meeting of auditors at the firm's Houston office and ordered "an expedited effort to destroy documents" on Oct. 23, the day after Enron disclosed that the S.E.C. had begun its inquiry, the firm said. The destruction apparently did not end until Mr. Duncan's assistant sent an e-mail message to other secretaries on Nov. 9 that said "stop the shredding," the firm said. Andersen had received a subpoena from the S.E.C. the day before." Id.

⁹⁸¹ Andersen was issued with a subpoena, a formal document to appear before the court as witness to testify and clarify some information needed by court.

⁹⁸² *Arthur Andersen LLP v. United States* 544 U.S. 696 (2005)

⁹⁸³ CUNNINGHAM, G. M. & HARRIS, J. E., *Enron and Arthur Andersen...*, op. cit., p. 34.

⁹⁸⁴ Id.

Andersen office to tie up loose administrative ends: a shameful end to a once highly esteemed auditing powerhouse.⁹⁸⁵

The significance of the Enron bankruptcy was that it not only led to the demise of Arthur Andersen, one of the Big Five accountancy firms, it also opened a Pandora's Box of scandals. Some few months after Enron other companies like WorldCom, Tyco, Xerox and Adelphia followed.⁹⁸⁶ These scandals, as indicated above, did not happen overnight. They were made possible by the continued relaxation of accounting and auditing standards over the years by the accounting profession for selfish ends. The scandals only helped to expose this fact.⁹⁸⁷

The importance and leadership of the US in the financial markets as in the free market world has never been in doubt. Accordingly, the US system of corporate self-regulation was equally celebrated and admired to be a model around the world for number of reasons adumbrated by ERIKSSON, like: "the absence of detailed technical rules makes it a flexible system, the emphasis is on the spirit rather than the letter of rules, persons concerned with a self regulation system are experts in their field, the responsibility of a person operating in a system of self regulation produces greater professional integrity and discipline, sanctions of disapproval and damaged reputation are much stronger than legal sanctions in this field, legislation is concerned with minimum standards and operates at the margin while self regulation is said to operate from a higher threshold and finally the system is not expensive since costs are borne by the market."⁹⁸⁸

The sudden collapse of Enron casted doubt on these beliefs and revealed inherent lapses in the US system which undermined the trust people had placed on the self regulation. This, in turn, created a 'crisis of confidence' in the US financial and capital markets. According to ALLES et al, prevailing public opinion on the cause of the corporate failures was that "it is due to deliberate fraud between managers, aided and abetted by

⁹⁸⁵ DRAKE, H., *The Legal Regulation...*, op. cit., p. 12.

⁹⁸⁶ COATES IV, J. C., "The Goals and Promise of the Sarbanes-Oxley", *Journal of Economic Perspectives*, 21, 2007, p. 91. For more details on these scandals, see KENNEDY, K. A., "An Analysis of Fraud: Causes, Prevention, and Notable Cases" Honors Theses, Paper 100, on <http://scholars.unh.edu/honors>

⁹⁸⁷ DEAKIN, S. & KONZELMANN, S. J., *Learning from Enron*, op cit., p. 5.

⁹⁸⁸ ERIKSSON, K., "Corporate Governance in the European Union Post-Enron", *Bond Law Review*, 15, 2003, pp. 190-191, accessed June 7, 2013 at <http://epublications.bond.edu.au/blr/vol15/iss1/9>

auditors, who, at best, are incompetent and, at worst, corrupt and outright compliant.”⁹⁸⁹ However, it was the report of the Enron Special Investigations Committee that set the stage for the debate that ensued.

The initial report by POWERS et al concluded that: “The tragic consequences of the related-party transactions and accounting errors were the results of failures at many levels and by many people: a flawed idea, self enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing to the limits. Our review indicates that many of those consequences could and should have been avoided.”⁹⁹⁰ Moreover Enron presumably adhered to what was considered good corporate procedure. But obviously, the system was open to abuse and the oversight model was ill-prepared to prevent it. A financial writer, SLOAN summed up the situation as follows:

The multilayered system of checks and balances that is supposed to keep a company from running amok completely broke down. Executives of public companies have a legal and moral responsibility to produce honest books and records – but at Enron they did not. Outside auditors are supposed to make sure that a company’s financial reports not only meet the letter of accounting rules but also give investors and lenders a fair and accurate picture of what is going on – but Arthur Andersen failed that test. To protect themselves, lenders are supposed to make sure borrowers are creditworthy – but Enron’s lenders were as clueless as everyone else. Wall Street analysts are suppose to dig through company numbers to divine what is really happening – but almost none of them managed to do that. Regulators did not regulate. Enron’s board of directors did not direct.⁹⁹¹

⁹⁸⁹ ALLES, M. G., KOGAN, A. & VASARHELYI, M. A., “Restoring Auditor Credibility: Tertiary Monitoring and Logging of Continuous Assurance Systems”, *International Journal of Accounting Information Systems*, 5, 2004, p. 188, 183-202.

⁹⁹⁰ Collapse of Enron: Hearing before the Committee on Commerce, Science, and Transportation, United States Senate, One Hundred Seventh Congress, second session, February 12, 2002. POWERS, the dean of the University of Texas School of Law and chair of the committee, went on to lament that “[a] flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple and not-so-simple accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits.” See NYT, February 5 2002.

⁹⁹¹ SLOAN, A., (2002) quoted from ERIKSSON, K., *Corporate Governance...*, op cit., p. 191.

The Enron case illustrates that US GAAP once regarded as the best and most rigorous accounting standards available seems to generate less powerful checks against abuse than many had believed. Although HARVEY PITT, the then chairman of SEC, argued before the Sarbanes Committee that the US regulatory system was still the best in the world. He nonetheless recognized that some reform of the system was necessary,⁹⁹² this reform, incidentally, turned out to be a direct regulation of the accounting profession enshrined in the Sarbanes-Oxley Act.

5.2 THE US REGULATORY RESPONSE TO ENRON

5.2.1 THE SARBANES-OXLEY BILL

The end result of those hearings was the Sarbanes-Oxley bill, named after its co-authors—Senator PAUL S. SARBANES and Congressman MICHAEL G. OXLEY. Despite the hysteria caused by the Enron collapse the bill still lacked general support at the beginning, mainly because of the effectiveness of the audit lobby in trying to block it. The eventual collapse of WorldCom in June 2002 served as the final straw to break the Congress' resistance. The Sarbanes-Oxley Act was signed into law on 30 July 2002 by President George W. Bush.⁹⁹³ The Act represent the most significant and far-reaching regulatory statute on public accounting since the Securities Acts of 1933 and 1934. The Sarbanes-Oxley Act, at its core, “was designed to fix auditing problem of US public companies, which is consistent with the official name of the law: the Public Company Accounting Reform and Investor Protection Act of 2002.”⁹⁹⁴

The Act is fundamentally meant “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other

⁹⁹² PITT, H. L., Chairman, U.S. Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, March 21, 2002. PITT stressed in his testimony the urgent “need to address three overarching reform needs. First, disclosure by public companies must be truly informative and timely. Of course, I should add here it has to be honest. Second, oversight of accountants and the accounting profession must be strengthened and accounting principles that underlie financial disclosures must be made more relevant and comprehensible. Third, the governance of American companies must be upgraded.” Id.

⁹⁹³ President Bush at the bill signing ceremony referred to the law as “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt” BUMILLER, E., NYT, July 31, 2002.

⁹⁹⁴ COATES IV, J. C., *The Goals and Promise...*, op. cit., p. 91.

purposes.”⁹⁹⁵ To achieve this goal and prevent the reoccurrence of the problems that led to the corporate failures, the Act seeks to improve the integrity of audits of public companies by removing undue influence on auditors. It requires that audit committees be composed of only independent directors.⁹⁹⁶ It also strengthens auditor independence by prohibiting acts that may lead to conflict of interest like performing audit simultaneously with lucrative non-audit work such as consulting.⁹⁹⁷ Above all it created a new accounting oversight board, the Public Company Accounting Oversight Board.

The Sarbanes-Oxley Act was hailed as the most important reform of American business practice since the Securities Acts of the 1930s.⁹⁹⁸ However, it also has some critics. It has been criticized for being a precipitated over reaction.⁹⁹⁹ It was pointed out that the fall of Enron does not validate the regulation of the accounting profession.¹⁰⁰⁰ BRANSON, on other hand argued that it should not be forgotten that self regulation had worked reasonably well over decades of unrivalled economic growth in US history. The Enron scandal might just be considered as an aberration which did not signify the meltdown of a whole system. He argued further that the Enron scandal together with others that followed Enron, were insignificant if compared with nearly 16,500 companies that file reports with SEC. However, what is worth noting about the Sarbanes-Oxley Act is that it was borne out of a public demand for reforms which was reflected in the unusually overwhelming bi-partisan support it received from the U.S. Congress.

The Sarbanes-Oxley Act is a package of reforms aimed restoring public confidence in badly damaged financial markets by ensuring accuracy in financial reporting thereby reducing the chances of a repeat of another Enron. The main reforms introduced by the Sarbanes-Oxley Act are considered below.

⁹⁹⁵ Sarbanes-Oxley Act 2002

⁹⁹⁶ WEGMAN J., “Government Regulation of Accountants: The PCAOB Enforcement Process” *Journal of Legal, Ethical and Regulatory Issues* 11, 2008, p. 79.

⁹⁹⁷ Id.

⁹⁹⁸ WEGMAN, J., “Impact of the Sarbanes-Oxley Act on Accountant Liability” *Journal of Legal, Ethical and Regulatory Issues*, 10, 2007, p. 1.

⁹⁹⁹ ERIKSSON, K., *Corporate Governance...*, op cit., p. 182.

¹⁰⁰⁰ BRANSON, D., (2003) quoted by ERIKSSON, K., *Corporate Governance...*, op cit., p. 191-92.

5.2.2 THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

The US Congress, dissatisfied with the track record of private self-regulatory bodies, was left with no conventional choice other than to innovate. As COATES argues, “Congress could have delegated to one of three traditional types of agents: 1) the executive branch of government, like an agency within the U.S. Department of the Treasury; 2) an independent agency, like the SEC; or 3) a private “self-regulatory” body, like the American Institute of Certified Public Accountants (AICPA) or the Public Oversight Board that had previously overseen auditors. However, each of these options risked leaving audit quality too low.”¹⁰⁰¹ That is how it came up with the PCAOB, the first major, and perhaps the most radical, reform introduced by the Sarbanes-Oxley Act.¹⁰⁰²

The financially independent PCAOB is neither a traditional private body, nor a public agency. Officially, it is a non-profit corporation with a legal mandate to “oversee the audit of public companies that are subject to the securities laws...in order to protect the interest of investors and further public interest in the preparation of informative, fair, and independent audit reports.”¹⁰⁰³ The body functions independently of the US government, and can only be disbanded by an Act of congress. The PCAOB is to oversee, inspect and investigate accounting firms. By virtue of section 102 of the Act, only firms registered with the PCAOB are allowed to perform audit for public traded companies in the US, and all are subject to the auditing, quality control, and ethics standards adopted by the PCAOB.¹⁰⁰⁴ Audit firms in the US were given until October 2003 to comply with the requirements of SOX while foreign firms will have up to May 2004 to comply. The fact that these foreign firms include about 280 companies from the European Union provoked a row between the EU and US. I will return to this later.

The PCAOB is the first semi-governmental agency created in the US to regulate the accounting profession, which eventually “ended the profession’s long standing tradition

¹⁰⁰¹ COATES IV, J. C., *The Goals and Promise...*, op. cit., p. 98.

¹⁰⁰² WEGMAN, J., *Government Regulation...*, op. cit., p. 76.

¹⁰⁰³ Section 101 SOX

¹⁰⁰⁴ Section 103 SOX

of self-regulation and peer review.”¹⁰⁰⁵ Although it performs the task usually ascribed to state organization and it is controlled by and reports to the SEC, the PCAOB is not a functionary of state.¹⁰⁰⁶ The PCAOB consists of five members who are appointed by the SEC in consultation with other federal agencies.¹⁰⁰⁷ These members must be of good reputation and demonstrate commitment and understanding of securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports.¹⁰⁰⁸ They are to hold office for a once renewable term of five years and may not be removed except for “good cause shown.”¹⁰⁰⁹ PCAOB is to be funded directly by public companies rather than by accountants,¹⁰¹⁰ to ensure that its members are independent of the accounting profession and less amenable to political pressures.¹⁰¹¹

The main function of the PCAOB is “to oversee the auditors of public companies, protect the interests of investors, further the public interest in the preparation of informative, accurate, and independent audit reports”,¹⁰¹² and generally, administer the accounting provisions of the Sarbanes-Oxley Act. To accomplish this task, the PCAOB follows the pattern of its predecessor agencies by means of hiring experts, promulgating rules, and setting up an enforcement mechanism for those rules. The PCAOB makes a further effort to ensure that fraud does not continue at the level of the external auditor. These functions are statutorily outlined as below, namely to:

- (1) register public accounting firms that prepare audit reports for issuers, in accordance with section 102;
- (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;

¹⁰⁰⁵ GOELZER, D.L., *Meeting the Challenges of the Changing Global Regulatory Environment*, Speech delivered on September 29, 2005 at the Moores Rowland International Annual Conference.

¹⁰⁰⁶ Section 101 SOX

¹⁰⁰⁷ Id.

¹⁰⁰⁸ Id.

¹⁰⁰⁹ Id.

¹⁰¹⁰ According to Section 109 of Sarbanes-Oxley Act, the PCAOB is to be funded through a levy placed on corporate issuers in proportion to their “equity market capitalization”.

¹⁰¹¹ WEGMAN, J., *Government Regulation...*, op. cit., p. 81.

¹⁰¹² Section 101 SOX and GOELZER, D.L., *Meeting the Challenges...*, supra.

(3) conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;

(4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;

(5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;

(6) enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and

(7) set the budget and manage the operations of the Board and the staff of the Board.

This, in practice, involves PCAOB staff being on-site with auditing firms to monitor their work. Unlike the POB before, the PCAOB “has authority to report deficiencies to the SEC, and provides a sanitized version of its inspection reports to the public. It reviews audit firm practices and policies on compensation, promotion, assignment, independence, client acceptance and retention, internal inspection, and training. If auditors fail to cooperate with its investigations, or if it finds violations, it may discipline auditors.”¹⁰¹³ Thus, where appropriate, the PCAOB can sanction errant auditors by way of fines, and in the worst case scenario deregister the auditor, which

¹⁰¹³ COATES IV, J. C., *The Goals and Promise...*, op. cit., p. 100. Their disciplinary powers are subject to review by the SEC and thereafter to the courts,

brings his or her practice to an end.¹⁰¹⁴ Although PCAOB acts independently of the SEC and manages its own budget, its budget, rules and standards still have to be approved by the SEC before they become effective.¹⁰¹⁵

5.2.3 AUDITOR INDEPENDENCE

The second important reform was to reinforce independence of auditors. Following numerous reports in the wake of the Enron scandal that point out weaknesses in the audit process, especially close relationship between management and auditors, the SOX introduced more rigorous procedures designed to give auditors independence from management. For example, under section 201 of the Act, auditors are prohibited from providing certain non audit services to their client. The section went on to list these services, which include bookkeeping, financial information system design, valuation services, actuarial services, internal audit outsourcing, management functions or human resources, broker/dealer services or investment adviser and legal services.¹⁰¹⁶ The firm can on the other hand engage in any non-audit service not listed in section 201 if it is approved in advance by the audit committee of the public company.

To reduce conflict of interest, the Act has forbidden audit services to any company whose chief executive officer or senior accounting officer were employed by that audit firm and participated in any capacity in the audit of that company in the preceding year. The Act further requires audit partner rotation every five years.¹⁰¹⁷ In direct response to the negligent behavior of auditors leading to recent financial crisis, the Act requires more detailed reports by the auditor to the audit committee regarding all critical accounting policies and practices.¹⁰¹⁸

5.2.4 THE AUDIT COMMITTEE

The third in line of reforms undertaken by the SOX was to strengthen corporate responsibility. In doing so the SOX gave board members a greater degree of independence by requiring that public companies' audit committees be composed solely of independent directors. A director will not be deemed independent if he receives other

¹⁰¹⁴ Id.

¹⁰¹⁵ Section 109 SOX

¹⁰¹⁶ ERIKSSON, K., *Corporate Governance...*, op cit., p. 195.

¹⁰¹⁷ Section 203 SOX

¹⁰¹⁸ Section 204 SOX

remuneration from the company apart from his compensation as member of the audit committee.¹⁰¹⁹ In the circumstances where a director is so closely affiliated with company that he or she may not be able to separate his or her interest with that of the company, he or she is disqualified to act as such. This however, does not necessarily prohibit a director from holding stock in the company.¹⁰²⁰

The SOX also enhanced the power as well as responsibilities of the audit committee by requiring chief executive officers (CEO's) and chief financial officers (CFO's) of public companies to personally certify to the accuracy of the financial reports and take complete responsibility for establishing and maintaining internal control structure and procedures for financial reporting.¹⁰²¹ Additionally, in a deliberate move to enhance the knowledge and competence of audit committee to enable it scrutinize better the financial statements, the Act requires that at least one member of the committee be a "financial expert". A financial expert is defined as someone "having experience as a public accountant or an auditor or financial officer, controller or principal accounting officer of an issuer".¹⁰²² However, this does not suppose that the financial expert member is to carry any "higher degree of responsibility than other members of the audit committee."¹⁰²³

To give teeth to the reform, the Act under section 305 empowers the SEC to (a) remove officers and directors from their positions, and to bar them from occupying similar offices at other public companies by simply demonstrating their "unfitness," and (b) institute an action in a Federal court to obtain "any equitable relief that may be appropriate or necessary for the benefit of investors."¹⁰²⁴ Further, the audit committee in carrying out its oversight duties might, when it deems necessary, engage the services of other independent accountants or consultants.¹⁰²⁵ According to ERIKSSON, the Act has

¹⁰¹⁹ It is worthy of note that NYSE and NASDAQ apply stricter measure of independence than the SOX. NYSE rule for example require that a board member should not have received compensation from the company for years while the SOX only emphasize on his current situation.

¹⁰²⁰ ERIKSSON, K., *Corporate Governance...*, op cit., p. 192.

¹⁰²¹ Section 302 SOX

¹⁰²² ERIKSSON, K., *Corporate Governance...*, op cit., p. 193.

¹⁰²³ Id.

¹⁰²⁴ Section 305 SOX

¹⁰²⁵ ERIKSSON, K., *Corporate Governance...*, op cit., p. 193.

effectively substituted the management and board of directors with the audit committee as the client of the auditing firm.¹⁰²⁶

5.2.5 CORPORATE ACCOUNTABILITY

With the Enron and other high profile scandals in mind, the authors of the Sarbanes-Oxley Act have the goal of reestablishing public trust in the financial statements. They were convinced that it is only by the creation and maintenance of norms of fairness and trust would the financial markets be sustainable. The Sarbanes-Oxley Act therefore pushed into the comfort zone of company CEO's and demanded more accountability and probity in the financial statements. Thus, under section 302 of the Act, chief executive officer and financial officers of public companies must "certify in every annual and quarterly report that they have read the report, that the report, based on their knowledge, does not contain any material misstatements or omissions and that the financial statements fairly present the financial condition and results of the company."¹⁰²⁷

This way, the Act sought to enhance financial disclosures by requiring companies to update and disclose material changes in their finances;¹⁰²⁸ protecting securities analysts from retaliation in case of conflict of interest with their mother firms;¹⁰²⁹ and enforcing corporate accountability. Particularly, the Sarbanes-Oxley Act places the responsibility for financial reporting and internal control on shoulders of chief executives' and financial officers' of the company by prescribing penalties for fraud as well as providing protection for whistle-blowers.¹⁰³⁰

Taken as a whole, this Act serves as a clarion call to auditors to be proactive in their review function. It clearly places more responsibility on auditors and practically ended their excuses of placing the blame on a particular corporation. The Act has also made it painfully clear that government regulators believe that the auditor's role of gatekeeper is of utmost importance and will no longer be taken lightly.

¹⁰²⁶ BRANSON, D., (2003) in ERIKSSON, K., Corporate Governance..., op cit., p. 193

¹⁰²⁷ Id at p. 194.

¹⁰²⁸ Section 401 SOX

¹⁰²⁹ Section 501 SOX

¹⁰³⁰ Section 801 SOX

6. EUROPE'S REGULATORY RESPONSE TO ENRON

6.1 THE EARLY RELUCTANCE

In the immediate aftermath of the corporate scandals in the US, the mood in Europe “was that they could not have happened in Europe because of the European emphasis on substance over form”,¹⁰³¹ in contrast with the US where reliance is placed more on accounting rules than principles, and greedy executives obsessed with forecasted earnings. In Britain, for example, the accounting profession was quick to argue that the scandals in the US were anomaly peculiar to US and did not reflect the then realities of British business environment. President of the Institute of Chartered Accountants in England and Wales further stated that the good corporate practice and financial regulation in place in the UK made it something like “an island of calm, proficient and virtuous practice.”¹⁰³² That was until the debacle in Royal Ahold came to light, a company based in Holland and the world's third biggest food retailer, disclosed that it had overstated its 2001 and 2002 earnings by almost US\$500 million, that all these claims turned out to be unfounded and a fool's paradise. Europeans then began to view the scandals as global problem.¹⁰³³

As indicated above, even before the scandals in the US the need for company and capital market law reforms had since been recognized by the European Union. The scandals only served as a reminder for its urgency.¹⁰³⁴ Moreover, the SOX requirement

¹⁰³¹ MOIZER, P., “A Review of Europe's Response to Audit Quality Concerns”, Leeds University Business School University of Leeds, UK, 2006, p. 3, accessed on June 10 2014 at www.eiasm.be/UserFiles/Peter%20Moizer.doc

¹⁰³² ERIKSSON, K., *Corporate Governance...*, op cit., p. 198; EVERS, L., “European view of UK accountancy – Do they really mean us?” *Accountancy*, p. 130, 2002.

¹⁰³³ Id. After these revelations, a piece in *The Economist*, Europe's Enron remarked that “now, at least, Europeans should stop smugly believing that corporate malfeasance is an American vice that cannot occur in the old continent. Instead, they should fix their corporate-governance and accounting problems with as much vigor as their American cousins showed after the Enron wake-up call.” *The Economist* February 27, 2002, p. 1. This scandal, followed by those of Parmalat in Italy and Nordisk Fjer in Denmark changed Europe's perception of the corporate scandal and served as a wakeup call on Europe's audit and financial regulation.

¹⁰³⁴ According to ERIKSSON, even before the Enron scandal came to the limelight, the Commission had in September 2001 “appointed the High Level Group of Company Law Experts. The High Level Group was composed of leading European experts on company law. Its original mandate in the area of corporate governance was to review whether and, if so, how the European Union should actively co-ordinate and strengthen efforts undertaken by member states to improve corporate governance. In a direct reaction to Enron the mandate was extended to cover “issues related to best practice in corporate governance and auditing, in particular concerning the role of the non-executive directors and supervisory board, management remuneration, management responsibility for financial information and auditing practices.” Id at p. 199.

that foreign companies reporting under US securities law, and their auditors, must comply with the provisions of the Act did not go down well with the EU. The EU considered this measure as another inconsiderate imposition of US regulations on it. The EU unsuccessfully sought for exemption for EU audit firms from registering with the PCAOB. The option left for the European legislators was to either respond by strengthening the EU statutory auditor law or be left at the mercy of the US PCAOB, given that the US regulators thought that existing EU legislation was too weak. Europe chose to take the challenge and move on as observed by the then EU Internal Market Commissioner Frits BOLKESTEIN:

We in the European Union were faced with a simple choice: Either we could oppose tooth-and-nail the Sarbanes-Oxley Act and add yet another fiery dispute to our post-Iraq bilateral relations, or we could try to find a constructive, cooperative way forward, jointly respecting to the maximum degree possible our different legal traditions and cultures. We decided on the latter.¹⁰³⁵

On 25 April 2006, the Council of the EU adopted Directive 2006/43/EC on the Statutory Audits of Annual Accounts and Consolidated Accounts. The Directive also known as the 8th Company Law Directive is an expanded version of the 1984 Directive which dealt with qualification of auditors in the EU member states. Directive 2006/43/EC, seen as the EU version of the SOX came into force in June 2006 and member states were required to implement it by June 2008.¹⁰³⁶ Directive 2006/43/EC enhanced the responsibilities and strengthened the independence of statutory auditors. It also improved external quality assurance process by seeking for better public oversight of the audit profession and close co-operation amongst member states oversight bodies.

Another move by the European Union to reform its audit market in the aftermath of the financial crisis began in 2010 with a European Commission consultation Green Paper entitled “Audit Policy: Lessons from the Crisis”. Following this consultation, the European Commission (EC) came up with Proposals in November 2011 and subjected them to debate. The outcome of these open discussions and debates, which took nearly

¹⁰³⁵ Speech by Internal Market Commissioner Fritz Bolkestein April 24 2003, accessed July 10 2013 at http://www.europa.eu.int/comm/internal_market/en/company/audit/news/index.htm.

¹⁰³⁶ The implementation process has since been concluded by the EU member states adopting the provisions of the Directive into their local audit laws. In Spain its result was the 2011 Audit law.

three years, was the two legal instruments, i.e. Directive 2014/56/EU on statutory audits of annual accounts and consolidated accounts, amending the Directive 2006/43/EC on statutory audits and Regulation (EU) No 537/2014 on statutory audit of public-interest entities containing additional requirements that relate specifically to statutory audits of Public Interest Entities, published in the Official Journal of the EU on 27 May 2014

Directive 2014/56/EU and Regulation (EU) No 537/2014 are both aimed at correcting some errors and deficiencies noted during the application of the 8th Directive by member states. The reform introduced measures to strengthen the independence of statutory auditors by making the audit report better and more informative, as well as improving audit supervision in the EU member states. These new measures of restoring investor confidence in the European market after the financial crisis will be taken in the following order:

6.2 THE AUDIT COMMITTEE

Directive 2014/56/EU mandates member states under article 39 to ensure that each public interest entity has an audit committee. The committee is to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity or, for entities without shareholders, by an equivalent body. The audit committee is required to have at least one member with financial competency while the rest of the members are required to have knowledge in the field of operation of the company. The audit committee is, among other things, responsible for monitoring the audit control and effectiveness of the company's internal control. The committee shall monitor and review the independence of the statutory auditors or the audit firms, where necessary. The committee is also responsible for the appointment of auditors or audit firm as the circumstances may require in accordance with the provision of the Directive.

Under this dispensation, the auditor is responsible to the audit committee and must report to the committee all matters of audit control, especially, material weaknesses in financial reporting. The auditor must every year provide the audit committee with an additional report consisting of sixteen items related to the work of the auditor, including

the independence declaration, the scope of the audit, the timing, the communication with audit committee, etc.¹⁰³⁷

6.3 AUDITOR INDEPENDENCE

Auditor independence is widely considered as the bedrock of the audit profession, and any crack in that foundation is a threat on the value of the audit which has direct consequences for investors and creditors, who may rely on the financial statements for their investment decisions. The concern about audit independence is instrumental to the debate on whether the performance of non-audit services for an audit client impairs auditor judgment and independence. The audit profession, on the other hand, has argued that their independence is not impaired by performance of non audit services, on the contrary it enhances audit. They further claim that non audit services do not present a conflict of interest, although the evidence indicates that they are often soft on clients when audit issues arise in order not to risk losing lucrative non-audit services. In fact, one of the fundamental reasons advanced as been responsible for the corporate scandals was familiarity between directors and auditors, which undermined their independence.

Therefore, Directive 2014/56/EU and Regulation (EU) No 537/2014 have introduced changes to strengthen auditor's independence. Provisions of the Directive are applicable to all statutory company audits while the Regulation applies to the audit of 'Public Interest Entities' (PIEs), especially, the additional independence requirements imposed by the Regulation for PIE audits under the amended article 5.

As seen earlier, the Directive mainly clarifies and specifies some provisions of the 2006 Statutory Audit Directive (2006/43/EC). The notable additions and amendments include, inter alia, the provision of article 1.2f of Directive 2014/56/EC, where the PIE has been redefined to include all companies listed on an EU regulated market together with other unlisted banking and insurance companies. Another is the requirement of independence from the audited entity that has now been expanded to include not only a statutory auditor or audit firm but also "any natural person in a position to directly or indirectly influence the outcome of the statutory audit."¹⁰³⁸

¹⁰³⁷ Article 11 of Regulation (EU) No 537/2014

¹⁰³⁸ Article 22.1 of Directive 2014/56/EC

The Regulation, which is the novelty of the two legal instruments, proposes for non-audit services fee limits for PIE audits under article 4.2. The article requires limiting the proportion of non-audit fees that can be incurred in a year, by reference to the average audit fee, which may be applied as follows.

1. The requirement applies at a group audit fee level, for PIE audits.
2. Group non-audit service fees may not exceed 70% of the average of group statutory audit fees over the previous three years.
3. For the provision to apply, the audit firm must have provided at least some non-audit services in each of the previous three years.
4. The restriction applies to non-audit services fees charged by the audit firm itself, not the services provided by other firms within the network.

In relation to non-audit services prohibition, on the other hand, the Regulation has preserved the existing basic notion of auditor independence standards, of an overall requirement for independence, the analysis of threats and the application of safeguards, together with a list (primarily for PIE audits) of prohibited non-audit service activities in respect of services by audit firms to the entities they audit.

In addition, the Regulation under article 5 has introduced a new list of prohibited activities for PIE audits. The new list covers the ground as current independence requirement except that it has a wider scope. As seen below:

- a. Tax – current requirements prohibit various types of tax service: the new ones cover substantially all tax work unless it has no material effect on the financial statements being audited;
- b. There is a virtually complete prohibition on several other activities where there are currently a number of caveats and exceptions, including internal audit and corporate finance;

- c. The prohibition on being involved in management activities now specifically includes (according to a Recital to the Regulation) working capital and cash management and providing financial information;
- d. The current exception for immaterial items is now restricted only to tax and valuation services;
- e. The provision of design and implementation of internal control over financial information and systems is now prohibited in the 12 months before appointment as auditors, as well as during the period of appointment.¹⁰³⁹

The Regulation has also made audit firm rotation mandatory under articles 16 and 17, such that PIEs have to appoint a new firm of auditors every 10 years. However, member states have the option to extend this maximum period to 20 years (24 if there is a joint audit) provided the audit is subject to a public tendering carried out after 10 years. Key audit partners are also required to rotate after seven years of appointment. Nonetheless, partners may be eligible to audit the said company again after two years. Furthermore, auditors are required under article 42 of the Directive to write an annual report to the audit committee on their compliance with independence requirements.

6.4 PUBLIC OVERSIGHT IN EUROPE

Directive 2014/56/EC requires all member states to appoint audit oversight boards, which will be responsible for the registration of audit firms; the adoption of national standards on audit ethics; quality control of audit firms and auditors as well as undertaking necessary disciplinary actions against audit firms.¹⁰⁴⁰

Other notable requirements of the amended Directive are the adoption of harmonized ethical and quality standards for audit firms across the EU; the creation of European Group of Auditors' Oversight Bodies (EGAOB)—a body responsible for coordinating the public oversight systems of statutory auditors across the EU. This body is required to provide technical assistance to the Commission on the implementation of the

¹⁰³⁹ Implementation of European Audit reforms, icaew, accessed October 29, 2015 at <http://www.icaew.com/en/technical/ethics/auditor-independence/implementation-of-european-audit-reforms>

¹⁰⁴⁰ Article 32 Directive 2014/56/EC

Directive; and finally, auditors and/or audit firms from ‘third countries’ must register in the EU and be subject to member state systems of oversight, quality assurance and investigations and sanctions.¹⁰⁴¹

7. COMPARISON OF THE SOX AND DIRECTIVE 2014/56/EC

The SOX and Directive 2014/56/EC have the same aim, which is to restore investor confidence in the financial markets after the spate of corporate scandals and accounting fraud that affected both sides of the Atlantic. They are also similar in great respect in that the Directive is widely believed to mirror the SOX and both are said to cover the same ground. In the following paragraphs we shall attempt to compare the two regulations.

7.1 PUBLIC OVERSIGHT BODIES

SOX and Directive 2014/56/EC have both established independent public oversight entity responsible for overseeing audit firms and the financial reporting process. For example in the EU, the European Group of Auditors’ Oversight Bodies (EGAOB) plays the same role as the Public Company Accounting Oversight Board (PCAOB) in the US.

In the US, all accounting firms carrying out audits for public companies must register with the Public Company Accounting Oversight Board. These firms are also required to file the names of the companies they audited in the previous as well as the companies they expect to audit in the course of the existing year. Accounting firms are also required to report the annual fees they received to the Board. Furthermore, accounting firms must prepare and submit to the Board their quality control policies on accounting and auditing practices. Accounting firms are required to submit to the Board a list of all their accountants who participated or contributed to the preparation of audit reports.

To carry out audit of public interest companies in Europe, audit firms are required to register with oversight bodies appointed by the member states. The audit firms must provide the list of their auditors as well as their registration numbers to the oversight body. All these information must be stored in electronic form and remain in the public

¹⁰⁴¹ This provision was controversial because it was generally viewed as retaliation to the requirement in SOX that European audit firms must register with PCAOB.

domain. Directive 2014/56/EC like the SOX also requires third country auditors carrying out audit of public companies to register as well. But unlike the SOX, Directive 2014/56/EC needs to be transposed and adapted by EU member states to their needs in accordance with the intent and spirit of the Directive. So while in the US PCAOB is mostly responsible for oversight function, in Europe member states may assign this function to one or more competent authorities.

Sarbanes - Oxley specifies the different authorities which are required to approve, register, inspect, oversee and investigate registered accounting while the 8th Company Law addresses the "competent authority" in general. In Sarbanes - Oxley PCAOB is mostly responsible for the upper mentioned tasks, while in Europe, member states designate these tasks to one or more competent authorities, as long as conflict of interest is avoided and the Commission is informed.

7.2 AUDITOR INDEPENDENCE

Auditor independence or better lack of it is the capital issue blamed for the recent financial scandals. Auditors owed their briefs to the management of their client for the simple reason that they are hired, paid and fired by the client not the public whose interest they are supposed to protect. This is arguably, inherently a compromising position. The introduction of audit committee by the SOX as well as the 8th Directive is aimed at eliminating or reducing the pressure that may be brought to bear on the auditors by their clients. Hence, the underlying premise of section 301 is to keep the auditor independent from audited company by giving the audit committee the responsibility of appointing the auditor. The auditor is also made answerable to the audit committee.

Unlike what is obtain in the US, in Europe composition of the audit committee is determined by the individual member states as prescribed by Article 41:

The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity.

Under the SOX all members of the audit committee should possess some financial expertise and at least one of them must be a “financial expert.” The Directive now requires one of the Audit Committee members to have competence in accounting or auditing instead of “basic financial understanding” while rest of the need to have knowledge of the business of the entity. The new Directive here corrects the bizarre position it earlier took by the EU of not emphasizing accounting competence for someone who is to oversee an activity related with finance.

7.3 THE AUDIT COMMITTEE

With respect to the powers of the Audit Committee, the SOX empower the Audit Committee to be directly responsible for the appointment, compensation, and oversight of the work of the auditors. The Directive on the contrary placed that responsibility on the shoulders of the ‘general meeting of shareholders or members of the audited entity,’ albeit, on the recommendation of the Audit Committee. It can be argued that giving the power of appointment of auditors to the shareholders may defeats the essence of the Audit Committee because it allows the controlling shareholder of a company to have the final say on the matter.

7.4 PROFESSIONAL RELATIONSHIP

Relationship between audit client and the auditor that goes beyond audit service is believed to engender friendliness that may eventually endanger the auditor’s independence. So to prevent this kind of relationship, both the SOX and the Directive contain provisions restricting non-audit and any additional services to the client that might compromise the auditor’s independence. Furthermore, the two regulations wanted to avoid continuous relationship between auditor and client that may sometimes compromise the auditor’s independence. So they both provided for auditor partner rotation. SOX for example, require five year rotation of lead or coordinating audit partner while Directive 2014/56/EC require rotation of audit partner for every seven years.

In addition, both the SOX and the Directive imposed a “cooling-off” period before an auditor may be allowed to take up a key management position with audited client, albeit, with a slightly different period of prohibition. Whereas the US established a waiting period of one year for audit firm partner who participated in any capacity in the

audit of the client, the EU chose a two year waiting period before such a partner could take appointment with a client

8. AUDITING STANDARDS AND QUALITY CONTROL

Under section 103 of SOX, the PCAOB is generally responsible for establishing and adopting auditing standards in the US while Europe prefers its auditors to carry out audits in compliance with international auditing standards. US accounting firms have usually used the Generally Accepted Accounting Principles (GAAP) as standard guidelines for financial accounting. Europe on the other hand requires all EU listed companies to use International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Committee (IASC). The EU's preference for the IFRS is not by chance, to say the least, but a design to draw the US to a more internationalized arena than what EU considers unilateralism on the part of the US. Although the US has signaled its readiness to explore that possibility, whether it will come fruition it is only time that will tell.

CHAPTER V

THE CASE FOR LIABILITY REFORM

1. INTRODUCTION: TOWARDS THE LIABILITY GAP

In recent times, audit liability has become a matter of increasing concern for the auditing profession. In a flurry of activities that followed the spectacular disintegration of Enron, the profession has witnessed significant transformation of its market structure, expansion in its duties vis-à-vis public companies, and the creation of a new regulatory oversight apparatus,¹⁰⁴² especially in the US. As is usual with financial turmoil, such as this, it exacerbated the longstanding polemic about the public's discontent with the actual nature and scope of audit work.¹⁰⁴³ Rather than going all out to improve audit quality, the profession, countered by claims about an inequitable reliance on the deep pockets of auditors.

These facts coupled with large claims and the escalating cost of indemnity insurance cover provoked a great deal of lobbying by firms for changes in the law to limit their liability exposure, an exposure some claim threatens the very viability of the industry. They aver that an outmoded corporate liability laws have made them disproportionately liable for a company's financial negligence, and that a major class action suit could vaporize another global accounting firm even with the minor contribution to the company's problem.

The Spanish version of disproportionate liability on the other hand is based more on the global trend than a serious evidence of liability claims. Although there have been some important judgments on audit liability cases, the calls for liability reduction in Spain predates these judgments, therefore can only be attributed to a global campaign by the major audit firms for reductions in auditor liability. The campaign incorporates a range

¹⁰⁴² Thus, for example, while the *Private Securities Litigation Reform Act of 1995* (PSLRA) shifted to proportionate from joint liability for auditors, the *Sarbanes-Oxley Act* imposes new demands on auditors that increase liability risk, including through new audits of internal control over financial reporting.

¹⁰⁴³ SAMSONOVA, A., Re-thinking auditor liability: The case of the European Union's regulatory reform, 2010, p. 2, accessed June 7, 2011 at http://apira2010.econ.usyd.edu.au/conference_proceedings/APIRA-2010-241-Samsonova-Re-thinking-auditor-liability.pdf The notion of audit expectations gap is discussed extensively in Chapter III.

of demands from liability caps to promoting the concept of proportionate liability.¹⁰⁴⁴ However, there are concerns from some quarters that the auditing industry is campaigning for liability concessions to protect it from possible lawsuits resulting from its own failures, thereby responding to an expanding expectation gap by filling the liability gap.

2. THE POLICY DEBATE OVER CATASTROPHIC RISK TO AUDIT FIRMS

Increased market capitalization of companies during the last decade has in a similar way significantly increased the risk of auditing such companies. At the same time, access to insurance for auditors has fallen sharply, especially for firms auditing international and listed companies, thus leaving partners in audit firms with an unattractive prospect of entirely bearing the liability risks themselves. This situation that has inspired academic and professional debate over the equitable nature of auditor liability and the potential risk that a successful lawsuit against the auditors could serve to bring down one of the major audit firms. A hard call indeed for politicians and regulators alike against the backdrop of a financial crisis that is yet to abate; with prominent Wall Street firms collapsing and disappearing, almost overnight; the federal government engaged in serial bailouts of financial troubled institutions; and the recent passage by the US government of a financial reform that essentially toughens the regulatory oversight on the entire financial services industry.

Obviously, in this volatile and changing landscape, proposal agitations for liability reform have received scant attention from U.S. regulators, as the more pressing business of the “credit crunch” commanded their attentions.¹⁰⁴⁵ Having said that, although governments and regulators had their attention diverted by a serious financial crisis that has gripped their economies, it is reasonable to argue that the debate over the fairness or otherwise of civil liability of auditors and the existential threat it poses to the audit profession is a continued and recurrent debate that is as old as the modern audit

¹⁰⁴⁴ GARCIA BENAÛ, M. A., ET AL., *Success in Failure...*, op. cit., p. 714.

¹⁰⁴⁵ DICKEY, J. C., “Auditor Liability “Caps”—The Politics of Catastrophe”, *Securities Litigation Report*, 5, Nov., 2008, p. 3.

itself.¹⁰⁴⁶ This fact is seen in two similar opinions that spanned about half a century apart:

The problem confronting the profession is to see to it that the liability is ‘clearly defined’, and that the extent of damages bears some reasonable relationship to the gravity of the accountant’s offence.¹⁰⁴⁷

We would not suggest that auditors should be freed from the threat of liability – as outlined earlier; exposure to liability is a driver of quality and should remain. But there needs to be some additional recognition of the fact that auditors do not ‘guarantee’ the accuracy of a company’s accounts or the integrity of the underlying records and that, in some cases, auditors can and are deceived by directors and management. We agree that auditors should be responsible for their own mistakes, but query whether they should be also held responsible for the failings, or wilful deceit, of other.¹⁰⁴⁸

As seen above, the audit profession has for many years complained about the continued rise of litigation against their members by both clients and other non-clients alike who have relied on their audit report in making decisions.¹⁰⁴⁹

The detractors of audit profession, on the other hand, would retort that such activity only goes to show a dwindling public confidence and the lack of trust the public have in the ability of auditors to perform their duties properly.¹⁰⁵⁰ The latter point of view may be substantiated by the two notable collapses directly linked with audit failure i.e., the cases of Enron in 2001 and Lehman Brothers in 2008. The profession would, nonetheless, emphasize that these are isolated cases that do not reflect their general performance in myriads of other companies they audit. Moreover, the level of litigation

¹⁰⁴⁶ HUMPHREY, C. & SAMSONOVA, A., in DI PIETRA, R., MCLEAY, S. & RONEN, J, editor(s), *Accounting and Regulation: New Insights on Governance, Markets and Institutions*, New York: Springer Science and Business Media, 2014, p. 112.

¹⁰⁴⁷ CAREY J. L., “The CPA Plans for the Future, American Institute of Certified Public Accountant”, New York, 1965, p. 415.

¹⁰⁴⁸ DAVIES J., “A Sharper Shield”, ACCA, October 1, 2014, accessed March 13, 2015 at www.accaglobal.com/gb/en/discover/ab-articles/audit-assurance/sharper-shield.html

¹⁰⁴⁹ DI PIETRA, R., ET AL., *Accounting and Regulation...*, op. cit., p. 112.

¹⁰⁵⁰ Id.

they face is inequitable, untenable and presents a risk of Armageddon to the profession, they claim.¹⁰⁵¹

In support of their argument, the auditors have cited some record claims brought against them in recent memory, like the £2bn case of the British insurance company, Equitable Life against Ernst and Young as well as the \$1bn claim brought against KPMG for the audit of the failed New Century Financial, as good examples of real existential threat the profession is faced with if such kinds of litigations were to succeed.¹⁰⁵² The auditing profession claims over liability threat is underpinned by its desire to fight against what it considers as an unfair regulatory policy behind the ‘epidemic of litigation’ it endures, i.e. the joint-and-several liability,¹⁰⁵³ which is discussed following.

3. JOINT AND SEVERAL LIABILITY AND DEEP POCKET THEORY: THE EXPANSION OF LIABILITY

The doctrine of joint-and-several liability was initially developed at common law as two separate theories of liability.¹⁰⁵⁴ The application of joint liability at common law was therefore strictly limited, applying only to joint tortfeasors who have conspired or acted in concert. However, if the parties did not act in concert, the law will not permit joinder, and hence joint liability, was disavowed.¹⁰⁵⁵ Joint liability *stricto sensu* is therefore originally related with issues of intentional torts because of the higher degree of intent involved in planning or acting in concert.¹⁰⁵⁶

Accordingly, in an action for recovery of damages where a plaintiff was injured as a result of the acts of two or more tortfeasors who did not act in concert, the plaintiff may

¹⁰⁵¹ Id.

¹⁰⁵² Id.

¹⁰⁵³ Joint and several liability presupposes that if several parties are liable for damages, the claimant can choose to sue all of the parties or one of them for the whole loss suffered. Therefore, in the case of financial loss with regards to errors in the financial statements, if both directors and auditors are liable for the loss sustained, the claimant may elect to sue either the directors or auditors for the whole loss, irrespective of who may be more culpable for the loss. More often than not, auditors are the ones sued and left to bear the full brunt of the damages awarded to the claimant perhaps for the simple reason that auditors are best placed to pay because of their ‘deep pockets.’

¹⁰⁵⁴ MEDNICK, R AND PECK, J. J., “Proportionality: A Much-Needed Solution to the Accountants’ Legal Liability Crisis”, Val. U. L. Rev., 28, 1994, p. 872, accessed June 7, 2012 at: <http://scholar.valpo.edu/vulr/vol28/iss3/3>

¹⁰⁵⁵ Id at p. 873.

¹⁰⁵⁶ *Smithson v. Garth*, 3 Lev. 324, 83 Eng. Rep. 711 (1691)

sue any or all of the parties individually and recover the whole damages. However, since they did not act in concert, the plaintiff is not allowed to join all the parties in one suit during the early stage of development of the doctrine.¹⁰⁵⁷ In addition, if the plaintiff recovers damages from one of the parties, he could not proceed further against the other defendants. For this reason, shrewd plaintiffs when filing their first claim, usually target defendants that are in a financial good position to shoulder the damages.¹⁰⁵⁸ These types of defendants came to be known as deep pocket defendants.¹⁰⁵⁹ Furthermore, since recovery could be obtained from any individual defendant irrespective of the defendant's degree of culpability, once the plaintiff recovers all of his damages in the first suit then he or she would not need to proceed further against the other defendants, a very good strategy from a procedural law standpoint that is both time-saving and efficient.¹⁰⁶⁰

As the doctrine developed in the course of time so did its application by courts, to allow plaintiffs join different defendants in a single suit so long as the harm produced by their separate negligent acts is one and indivisible.¹⁰⁶¹ Moreover, the plaintiffs were free to choose the way they deem expeditious to recover from the defendants, and one defendant had no legal right to seek contribution from other defendants.¹⁰⁶² The practice of joining defendants who acted separately but their actions created one indivisible harm, gained notoriety among plaintiffs for its simplicity from procedural standpoint. The concept of joint-and-several liability came to be enshrined as an integral part of the tort system.¹⁰⁶³

The challenges in the apportionment of liability led to the emergence of concept of contributory negligence, where the plaintiffs must demonstrate to the court that they have not in any way contributed to the resultant damage they suffered.¹⁰⁶⁴ Usually, once the court decides that defendants were negligent the next question then was how much

¹⁰⁵⁷ More over an action against one of the tortfeasors automatically bars any further action against the rest of the tortfeasors, see MEDNICK, R AND PECK, J. J., "Proportionality...", op. cit., p. 872. See also WADE, J. W., "Should Joint and Several Liability of Multiple Tortfeasors be Abolished?", *AM J. Trial Advoc.*, 10, 1986, p.194.

¹⁰⁵⁸ *Id* at p. 873.

¹⁰⁵⁹ *Id.*

¹⁰⁶⁰ *Id.*

¹⁰⁶¹ *Id.*

¹⁰⁶² *Id.*

¹⁰⁶³ *Id.*

¹⁰⁶⁴ *Id.*

damage the defendants should collectively pay rather than the individual defendant's degree of culpability.¹⁰⁶⁵ It is poignant nonetheless, to point out that some states in the United States eventually adopted the concept of "comparative liability" in order to alleviate the excesses of joint-and-several liability. Pursuant to the application of "comparative liability" the percentage of individual defendant's fault came to determine the amount he paid known as comparative contribution. This rule apart, each defendant is, ipso facto, still liable for the full amount of damage to the plaintiff, regardless of the percentage of fault assigned.¹⁰⁶⁶

Auditors believe that the system of joint-and-several liability if not checked is capable of crippling the auditing profession. Moreover, they argue that if harm is capable of apportionment amongst multiple tortfeasors, it is only equitable that a single tortfeasor should be liable to the extent of his/her fault. Auditors sustain that the likely scenario is that they are the ones left to shoulder the entire burden, as the equitable distribution of judgment award often sacrificed because of complex and difficult task of aligning the degree of each of the tortfeasor's liability to the proportion of his/her fault.¹⁰⁶⁷

In addition, auditors believe they are targets of unjustifiable litigation because they were held liable to mere negligence standard. This is in contrast with directors and officers of companies who are often protected by the business judgment rule, which incorporates a standard of gross negligence.¹⁰⁶⁸ Thus, given the different standards applied to accountants and directors, there may be circumstances where auditors will be found

¹⁰⁶⁵ Id.

¹⁰⁶⁶ Id at p. 874. Another theory developed by the court is "alternative liability" as a parallel theory of liability "to address situations where one of two or more defendants individually caused the injury to the plaintiff, but where the defendant causing the injury cannot be satisfactorily identified. This is the textbook case of *Summers v. Tice*, 199 P.2d 1 (Cal. 1948), where two hunters aimed carelessly and shot in the direction of the plaintiff. At trial, the plaintiff could not say with certainty which of the defendants had caused his injury. The court held both defendants liable and did not require the plaintiff to identify the defendant actually at fault. Under these circumstances, each defendant must prove that he did not proximately cause the plaintiff's injury or be liable jointly and severally with his codefendant(s). This theory of alternative liability was adopted primarily because public policy dictated that the plaintiff should not be without a remedy where the harm was clear, but the cause was ambiguous. This shifting of the burden of proof was eventually adopted by the *Restatement*. RESTATEMENT (SECOND) OF TORTS S. 433(B) (3) (1965)." MEDNICK, R AND PECK, J. J., "Proportionality...", op. cit., p. 873.

¹⁰⁶⁷ MANISERO, T. R., & SALEM, C., The Common Law Doctrine of Joint and Several Liability and The Realistic. Implications of the "Deep pocket" Rule, Wilson Elser, p. 1, accessed July 10, 2014 at: http://www.wilsonelser.com/files/repository/NatlJointSevLiability_Manisero.pdf

¹⁰⁶⁸ SMITH, B., The Professional Liability Crisis and the Need for Professional Limited Liability Companies: Washington's Model Approach, *Seattle University Law Review*, 18, p. 568.

liable, while the directors of the company are exculpated.¹⁰⁶⁹ This argument reechoes the concern expressed by the Supreme Court of California in *Bily* as follows:

An award of damages for pure economic loss suffered by third parties raises the specter of vast numbers of suits and limitless financial exposure.... The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.¹⁰⁷⁰

Auditors also find themselves at the receiving end of liability because they are the only solvent parties standing when business goes bankrupt.¹⁰⁷¹ Particularly, the larger audit firms who have become targets of litigation because of their substantial amount of capital built up. The assets and insurance coverage of these firms have made them vulnerable to what is now referred to as the "deep pocket" theory. The "deep pocket" syndrome, auditors believe, is the forbear to the much dreaded doctrine of joint-and-several liability.¹⁰⁷² By the application of this doctrine, even though auditors may be less culpable for the loss of the plaintiff, they are liable for the entire amount of damage if found negligent. This, in turn, encourages plaintiffs to directly go after the auditors because of their deep pockets.¹⁰⁷³

If one may add, another reason auditors are being targeted is perhaps, because the public is looking for someone to hold responsible for their loss. According to SMITH, moments of crisis are usually followed up by low public perception of professionals, like auditors, who were in principle, deemed partly responsible for it.¹⁰⁷⁴ As it is typical with crisis, there is a public outrage that somehow serves to fuel an increase of lawsuits against auditors that sometimes help to satisfy the public's desire for retribution. In addition, auditors have been sued for performing at a substandard or even fraudulently colluding

¹⁰⁶⁹ *Id.*

¹⁰⁷⁰ *Bily*, 834 P.2d at 763.

¹⁰⁷¹ SMITH, B., *The Professional Liability Crisis...*, op. cit., p. 568.

¹⁰⁷² *Id.*

¹⁰⁷³ *Id.*

¹⁰⁷⁴ *Id.*

with the company or making it easier for the companies' management to deceive investors and regulators.¹⁰⁷⁵

4. AUDITORS' CALL FOR INCREASED PROTECTION: CASHING IN ON PROPORTIONATE LIABILITY

The grouse of auditors with liability litigations is based on a simple and common legal notion that damages are apportioned in accordance with a party's fault. As trite and logical as this precept may sound, it is untenable under tort liability claims against auditors because of the doctrine of joint-and-several liability.¹⁰⁷⁶ Consequently, a plaintiff in a claim for damages may proceed against any tortfeasor of his or her choice to recover the entire amount of his or her loss, with no regards whatsoever to the defendant's contribution to the loss. Thus, if an auditor who conducts audit of a company fails to detect a fraud by the director of the company, the claimant has the option to sue either the auditor or the director to recover his full loss, irrespective of who is more culpable of the two. In practice, it is the auditor who is always sued because of the capacity he or she has to shoulder the bill.¹⁰⁷⁷ For this reason, auditors are very often are forced to settle an unwarranted claim to avoid the arduous task of litigation with a potential risk of unlimited liability exposure.¹⁰⁷⁸

In addition, juries in the United States, like the general public, have difficulty in overcoming the assumption that auditors investigate and validate all the transactions undertaken by their clients. This difficulty faced by "deep pocket" defendants in convincing a jury that auditor's function is not necessarily equivalent to detecting all the errors in the financial statements of clients often propel auditors to opt for settling an unwarranted claim.¹⁰⁷⁹

Overwhelmed by disproportionate liability regimes, auditors have sought for a statutory reform that will replace the joint-and-several liability with a more constrained liability

¹⁰⁷⁵ Id at p. 569.

¹⁰⁷⁶ MANISERO, T. R., & SALEM, C., *The Common Law...*, op. cit., p. 867.

¹⁰⁷⁷ The auditor may seek a contribution from other co-defendants for an equitable amount but the co-defendants are often unable to meet this liability. In the end, liability is imposed upon the defendant that has the means and better placed to pay, rather than the most negligent.

¹⁰⁷⁸ SMITH, B., *The Professional Liability Crisis...*, op. cit., p. 569

¹⁰⁷⁹ Id.

arrangement, such as capped or proportionate liability.¹⁰⁸⁰ This method involves setting a cap on the amount of damages that a potential claimant can claim against the auditor or that damages awarded are measured in proportion to the degree of auditor's fault. With this proposition, the audit profession embarked on an active campaign, engaging political actors as well as regulators to their cause of reform, both at national and international levels. However, the success of those efforts has so far being mixed.¹⁰⁸¹

Whereas some countries, especially in the aftermath of the Enron scandal, have re-examined their rules governing the liability of auditors, others have adamantly refused to limit the liability of auditors.¹⁰⁸² In the United States, for example, auditors cannot contractually limit their liability for negligence and as evidenced in the philosophy behind the passage of the Sarbanes-Oxley Act, this situation is not likely to change anytime soon. Similarly, as discussed extensively in Chapter III, under Spanish law, liability of auditors is tortuous and cannot be limited in anyway.¹⁰⁸³

Auditor liability litigation in the United States has long been an area of concern right from the early 1970s. The influx of liability litigation in this period of United States' history is attributed in part to the provision of section 10(b) of the Securities Exchange Act of 1934 which prohibits fraud in transactions that involves the sale or purchase of securities.¹⁰⁸⁴ This section invariably creates liability far beyond fraud to include any misstatement or omission of a material fact, or any relevant information that would be important to investors in taking the decision to buy or sell the stock. Because of its broad application, the Exchange Act antifraud provision has been used against all kinds of behavior, from misleading statements in company filings and documents used to sell the securities.

Moreover, investors may also sue under Title 18 of the US Code for fraudulent statement in a company's periodic filings with the SEC. Although difficult to prove, Title 18 gives the private right of action to investors, which is advantageous because it

¹⁰⁸⁰ DI PIETRA, R., ET AL., *Accounting and Regulation...*, op. cit., p. 113.

¹⁰⁸¹ *Id* at p. 114.

¹⁰⁸² As a result of a successful lobbying campaign by the auditing profession, countries like Australia, Belgium and Germany have adopted some statutory measures to limit the liability of auditors.

¹⁰⁸³ Any applicable cap to liability in Spain must be in accordance with the adapted provisions of the 8th Directive to be discussed further.

¹⁰⁸⁴ DI PIETRA, R., ET AL., *Accounting and Regulation...*, op. cit., p. 119.

creates potential liability for a wide range of defendants, including those who actually made the fraudulent statement, “control persons,” and their aiders and abettors. This fact, coupled with liability insurance coverage enjoyed by auditors made them convenient litigation targets.

The legal theory of aiding and abetting soon became the basis of a flurry of liability actions even by individuals remotely associated with sale and purchase of securities. While securities actions can be said to represent only a fraction of liability claims brought against auditors, these suits generally popularized claims against auditors and practically open the flood gate of litigations against auditors. Auditors particularly have become targets of litigation because of the nature of their work. They are called to evaluate and exercise considerable judgment on materials and documents prepared by others in an environment not fully controlled by them. The complex scenario of auditor’s work was well expatiated the Supreme Court of California in the case of *Bily* as follows:

An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents ... [and] necessarily furnishes the information base for the audit...Thus, regardless of the efforts of the auditor, the client retains effective primary control of the financial reporting process.¹⁰⁸⁵

In his or her examination of the audit materials and documents, the auditor must follow the requirements of Generally Accepted Accounting Standards (GAAS). Likewise in reaching an opinion on the audit he or she is to be guided by Generally Accepted Accounting Principles (GAAP). Both of these guidelines are set rules written in general terms and their application is fundamentally based on individual auditor’s experience and professional judgment.

Investors and the general public may seek a flawless or perfect audit but by its nature an audit is an exercise of estimation and judgment, therefore it is hardly perfect. Thus, in

¹⁰⁸⁵ *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992)

the *locus classicus* of *Bily v. Arthur Young & Co.*, the California Supreme Court reasoned that “an audit report is not a simple statement of verifiable fact that, like the weight of the load of beans...can be easily checked against uniform standards of indisputable accuracy. Rather, an audit report is a professional opinion based on numerous and complex factors. The court went on to conclude that the audit report is “the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.”¹⁰⁸⁶ In other words, audit is “as much an art of judgment and experience as an axiomatic set of procedures.”¹⁰⁸⁷

5. EARLY LEGISLATIONS TO STEM LIABILITY CLAIMS

Auditors have for long complained about disproportionate threat they face. Although for some analysts, the threat of litigation is another means of enhancing auditors’ professional responsibility and thereby increasing the reliability of financial information. Nevertheless, “the threat of class action securities fraud litigation creates great financial risk for the profession,” and auditors cannot find insurance for it.¹⁰⁸⁸ Thus, even before the advent of the SOX, the accounting industry sought relief from Congress from litigation targeting deep pocket defendants. As indicated earlier, “auditors are a favored target of trial lawyers because any faulty judgment on the part of auditors may result in large monetary settlements. Accountants were also concerned about abusive discovery practices that imposed such burdensome costs that expensive settlements often were necessary.”¹⁰⁸⁹

Thus, in 1991 the audit firms successfully lobbied various states to pass enabling legislation for the establishment of *Limited Liability Partnership* (LLP). Traditionally, audit firms practiced as unlimited liability partnership in which all assets of the firm as well as personal assets of partners were at risk once the firm is found liable by a court of

¹⁰⁸⁶ *Bily*, 834 P.2d at p. 763.

¹⁰⁸⁷ MEDNICK, R AND PECK, J. J., “Proportionality..., op. cit., p. 883.

¹⁰⁸⁸ PEARSON, T. C. & MARK, G., *Investigations, Inspections...*, op. cit., p. 50.

¹⁰⁸⁹ *Id.*

law.¹⁰⁹⁰ Whereas the liabilities of audit partners in case of a limited liability audit firm are limited to their personal contribution to the capital of the firm. Almost all audit firms in the US are now LLP's.¹⁰⁹¹

The second stage of this development was the effort by the audit firms to reform the joint-and-several liability which was also rewarded with the US Congress overriding a presidential veto and passed the *Private Securities Litigation Reform Act* (PSLRA) in 1995.¹⁰⁹² The PSLRA was primarily an effort to prevent meritless “strike suits,” and it succeeded in part because it altered the nature of securities litigation against companies and their auditors. Large institutional shareholders became more involved in securities class actions because the PSLRA ceded control of such actions to the largest investor. The PSLRA minimized the exposure of external auditors by establishing a system of proportional liability that reduced the potentially devastating consequences of joint-and-several liability.¹⁰⁹³

The PSLRA deterred both nuisance litigation and some unmeritorious cases. Further, the Act served as a precursor to SOX by expanding the legal reporting responsibilities of auditors. For the first time, statutory law required some specific “audit procedures,” including procedures reasonably designed to detect material illegal acts related to the financial statements of public companies.¹⁰⁹⁴ This was followed in 1998 by the *Securities Litigation Uniform Standard Act* (SLUSA). These laws, the LLP laws at States’ level and the PSLRA and SLUSA at national level restricted claims to a proportionate liability model, except in cases where auditors commit criminal offence then joint-and-several liability remains.¹⁰⁹⁵

Meanwhile, auditors’ campaign against the so-called liability ‘epidemic’ still continues in the United States today. However, it is worthy of note that securities laws did not come from the blues, they were measures undertaken to protect investors after an earlier financial catastrophe provoked by manipulation and greed as seen below.

¹⁰⁹⁰ This liability took the form of joint-and-several, exposing audit partners to respond to the liability obligations of their bankrupt co-defendants in fraud cases.

¹⁰⁹¹ BUSH, T., ET AL., Auditor Liability Reforms..., op. cit., p. 8.

¹⁰⁹² PEARSON, T. C. & MARK, G., Investigations, Inspections..., op. cit., p. 51.

¹⁰⁹³ Id.

¹⁰⁹⁴ Id at p. 52.

¹⁰⁹⁵ BUSH, T., ET AL., Auditor Liability Reforms..., op. cit., p. 10.

6. EVOLUTION OF AUDIT REGULATION IN THE UNITED STATES

Historically, crisis and regulation are not strange bedfellows, especially in the financial services industry.¹⁰⁹⁶ Auditor regulation in the United States was first contemplated after an earlier financial crisis that came to be known as the Great Depression. During the years that followed the World War I, the United States economy witnessed a rapid strong growth.¹⁰⁹⁷ With the economic expansion and surplus money, many individuals began to invest in stocks of publicly traded companies. This surge in investment activities led to calls in certain quarters for some form of government oversight and regulation of the financial sector, which fell into deaf ears. The main goal of both the government and businesses then was to turn on profit and expand the economy.¹⁰⁹⁸

In its formative years, investing in stock markets was unregulated and speculative. Practically, it was a free market in the most basic form, a sort of *caveat emptor* transaction with its inherent systemic problems.¹⁰⁹⁹ It was an unfettered atmosphere of demand and supply, where corporations wanted capital and eager investors were willing to invest their money without any regards to whether the market was regulated or not. Corporations took advantage of this situation to artificially inflate stock prices to make them more attractive, while lenders were as well inflating interest rates. These factors, coupled with increase in stock purchase on the margin provoked the “final expansion and crash of the stock markets.”¹¹⁰⁰ The general sentiment was that the bubble created by the surge and eagerness to invest in stock markets had finally busted. But it was a later revelation of stock manipulation that ignited fear among the American public, this in turn created panic and rush to sell off their stocks that eventually caused the 1929 stock markets to crash. The Dow Jones Industrial Average lost most of its value with many investors losing their fortunes, a dire economic situation that ushered in the Great Depression.¹¹⁰¹

¹⁰⁹⁶ JONES argues that long before the recent financial crisis, the U.S. Congress has been engaged in ‘conduct regulation’ with statutes like The Williams Act of 1968 and The Foreign Corrupt Practices Act of 1977. See JONES, R. “Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate” *Wake Forest Law Review* 41, 2006, p.109, accessed May 21, 2012 at: http://works.bepress.com/renee_jones/9

¹⁰⁹⁷ SPELL, S. M., “Capping Auditor Liability: Unsuitable Fiscal Policy in our Current Financial Crisis”, *Brook. J. Corp. Fin. & Com. L.*, 4, 2010, p. 329.

¹⁰⁹⁸ Id.

¹⁰⁹⁹ Id.

¹¹⁰⁰ Id.

¹¹⁰¹ WEGMAN J., “Government Regulation of Accountants: The PCAOB Enforcement Process” *Journal of Legal, Ethical and Regulatory Issues*, 11, 2008, p. 77.

The Great Depression completely shattered the United States' economy. Investors were left with of over 25 billion dollars of worthless stocks in their possession and there was disillusionment and mistrust everywhere. Individual investors, corporations, banks, and the general public feared for the nation's financial sector and economy.¹¹⁰² Then, the erstwhile unpopular idea of federal regulation of securities markets is almost inevitable because the spread of this crisis required a national solution.¹¹⁰³ The responsibility of solving the problem fell squarely on the Congress, the only national body competent and best suited to handle it.¹¹⁰⁴

As earlier pointed out in this thesis, the regulation of auditing under US corporate law consists of both federal and state legislations. The power to regulate any activity directly or indirectly related to interstate commerce is constitutionally vested in the US congress.¹¹⁰⁵ DRAKE argues that "as a corollary, each state has the implied right to legislate on such interstate commercial activity that has been left unregulated by the congress."¹¹⁰⁶ Simply put, American corporate law consists of two 'parallel and interlocking systems' of state corporate law which regulates the internal affairs of corporations and federal law which establishes a national policy for the securities markets.¹¹⁰⁷ The division of authority envisaged between federal and state officials is nonetheless, not sacrosanct. According to JONES, "the tradition of respect for state authority in securities regulation has significantly eroded", as the U.S. Congress had increasingly intervened whenever necessary to decisively remedy a problem traditionally left to state law. One such situation was the promulgation of the Securities Act of 1933 after the stock crash of 1929.¹¹⁰⁸

Following the Great Depression, the Congress immediately embarked on the task of looking into the causes of the financial crisis with a view of finding and effecting solution to the problem as well as restoring the financial markets. This took the form of holding hearings across the spectrum of stakeholders, such as investors, creditors, banks and corporations. In the course of several months of hearing, there seem to be "a

¹¹⁰² SPELL, S. M., *Capping Auditor Liability...*, op. cit., p. 330.

¹¹⁰³ *Id.*

¹¹⁰⁴ WEGMAN J., *Government Regulation...*, op. cit., p. 77.

¹¹⁰⁵ On the power of the Congress of the US, please refer to Article 1 section 8 of the United States Constitution.

¹¹⁰⁶ DRAKE, H., *The Legal Regulation...*, op. cit., p. 17.

¹¹⁰⁷ DRAKE, H., *The Legal Regulation...*, op. cit., p. 17.

¹¹⁰⁸ JONES, R. *Does Federalism Matter...*, op. cit., pp. 109-11.

consensus that for the economy to recover, the public's faith in the capital markets needed to be restored.”¹¹⁰⁹ This challenge would not be an easy one given the level of mistrust and frustration created by enormous resources lost to the financial markets crash.¹¹¹⁰

After several years of consultation and legislative work, the Congress came up with important and successive legislations in order to restore public trust in the economy. The series of legislative effort to fix loopholes in the capital markets began with the Securities Act of 1933. It was then followed up with the Securities Exchange Act of 1934. The Congress also created the Securities and Exchange Commission (SEC), an independent body to oversee the functioning of the financial markets.¹¹¹¹

6.1 SECURITIES AND EXCHANGE ACTS OF 1933 AND 1934

As a response to a deep financial crisis brought about by manipulations and fraud, these Acts were based upon the philosophy of honesty and transparency in securities dealings.¹¹¹² This in essence, means that all issuers of securities are required to disclose all material information that a potential investor would require to reach an informed decision on whether to invest in such securities or not.¹¹¹³ The Acts imposed new financial reporting and disclosure requirements and prohibited certain practices, such as insider trading.¹¹¹⁴ The Acts also made auditing of public companies in the United States obligatory¹¹¹⁵ and placed its administration under the SEC.¹¹¹⁶

¹¹⁰⁹ SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, accessed July 8, 2014 at: <http://www.sec.gov/about/whatwedo.shtml>

¹¹¹⁰ SPELL, S. M., Capping Auditor Liability..., op. cit., p. 331.

¹¹¹¹ Id.

¹¹¹² Id.

¹¹¹³ Id.

¹¹¹⁴ JONES, R. Does Federalism Matter..., op. cit., p. 108.

¹¹¹⁵ Until then auditing of public companies was not compulsory across the United States and was merely required and encouraged by some state laws and stock markets like the New York Stock Exchange.

¹¹¹⁶ Section 19(a) Securities Act of 1933. The accounting authority now held by the SEC was held briefly by the Federal Trade Commission until the SEC was created by Section 4(a) of the Securities Exchange Act of 1934.

6.2 SECURITIES AND EXCHANGE COMMISSION (SEC)

The SEC was established under Securities Exchange Act 1934 The SEC with a mission to “restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.”¹¹¹⁷ To accomplish this goal, the SEC has adopted two major initiatives. First, all companies offering securities to public for investment are required to reveal the true state of their finances, the exact types of securities they are selling, and the risks involved in investing in such securities. Second, all persons that are involved in the financial markets, including brokers, dealers, bankers, and exchanges are required to treat investors honestly, fairly and must put the interest of investors first.¹¹¹⁸

Other methods employed by the SEC to attain its statutory goals is through the free flow of information transmitted to the public through various reporting requirements that publicly traded corporations were required to fulfill.¹¹¹⁹ One important way that the SEC uses to ensure that information that emanates from corporations are accurate is by means of mandatory external audits. Once companies fulfill the various disclosures necessary to inform the shareholder of their financial status, an external accountant must audit the forms.¹¹²⁰

The SEC also acts as central authority responsible for oversight and discipline of the accounting profession, as well as forming and adopting accounting and auditing standards.¹¹²¹ This authority was however sparingly employed by the SEC preferring instead to delegate the function to self-regulation of the accounting profession’s principal trade association, the American Institute of Certified Public Accountants (AICPA) and other non-governmental organizations like Financial Accounting Standards Board (FASB) and Independence Standards Board (ISB).¹¹²²

¹¹¹⁷ SPELL, S. M., Capping Auditor Liability..., op. cit., p. 331, was citing SEC, The Investor’s Advocate *supra*.

¹¹¹⁸ Id.

¹¹¹⁹ Id.

¹¹²⁰ Id. See also Turner, L. E., Chief Accountant, SEC, Speech sponsored by Washington University School of Law and the Institute for Law and Economic Policy, Scottsdale, Arizona: Audit Committees: A Roadmap for Establishing Accountability (Mar. 10, 2001), accessed June 5, 2011 at <http://www.sec.gov/news/speech/spch469.htm>

¹¹²¹ These standards include the creation of independent standards for auditors.

¹¹²² The SEC uses these organizations to create and implement auditing and accounting standards and rules, but still maintains disciplinary powers.

The AICPA on the other hand established the Public Oversight Board (POB) and charged it with the task to oversee the work of public accountants. But the POB was unable to effectively undertake this task due to its lack of authority to sanction errant auditors.¹¹²³ For instance, in a disagreement over the POB's plan to review the BIG FIVE¹¹²⁴ accounting firm's compliance with auditors' independence standards, the AICPA cut off funding for the POB. Finally, in 2002 the POB voted unanimously to disband for inability to fulfill its mission.¹¹²⁵

The AICPA had also created the Auditing Standards Board (ASB) for the purpose of standard setting. However, there was dissatisfaction with the work of the members of the ASB, mostly practicing accountants, who were seen to be more protective of their colleagues than serving the public interest.¹¹²⁶ As expressed in no equivocal terms by LYNN TURNER, former SEC Chief Accountant at the Enron Congressional hearings in the following words:

Those standards tend to be written to protect the accounting firms in case they get in trouble on an audit ...it is not drafted with the public interest in mind ... As long as you leave that standards setting process in the hands of the firms and of the firm's legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public.¹¹²⁷

In the wake of a number of high-profile accounting scandals, highlighted by the Enron meltdown and the foregoing testimony, among others, adduced before the congressional hearing, the U.S. Congress came to the conclusion that self-regulation by the accounting profession had been inadequate as a model for oversight and standard setting.¹¹²⁸ The

¹¹²³ WEGMAN, J., "Impact of the Sarbanes-Oxley Act on Accountant Liability", *Journal of Legal, Ethical and Regulatory Issues*, 10, 2007, p. 4.

¹¹²⁴ These were the five largest international accounting firms, responsible for the majority of audits performed on private as well as publicly traded companies, namely, PricewaterhouseCoopers, Deloitte Touch Tohmatsu, Ernst & Young, KPMG and Arthur Andersen in the wake of the Enron debacle. They, however, became the BIG FOUR after the demise of Arthur Andersen in 2002.

¹¹²⁵ WEGMAN, J., *Impact of the Sarbanes-Oxley Act...*, op. cit., p. 4.

¹¹²⁶ Id.

¹¹²⁷ Please see Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings before the Senate Committee on Banking, Housing and Urban Affairs quoted herein from WEGMAN, J., *Impact of the Sarbanes-Oxley Act...*, op. cit., p. 4.

¹¹²⁸ WEGMAN, J., *Impact of the Sarbanes-Oxley Act...*, op. cit., p. 4.

need to correct these excesses and protect the general public from the abuses of the recent past prompted the passage of the Sarbanes-Oxley Act.¹¹²⁹

7. AUDIT REGULATION IN SPAIN

Accounting regulation in Spain is relatively a new phenomenon.¹¹³⁰ Unlike the experience obtained in the US and other industrialized countries, where a long standing audit tradition became a sine qua non for the development of their financial markets and economies, in Spain these conditions were not achieved until well into the 1960s.¹¹³¹ In fact, prior to the Audit law of 1988, there was no legislation regarding obligatory filing and publication of annual financial statements.¹¹³² Although auditing was legally required by the 1951 “Ley de Sociedades Anónimas”,¹¹³³ its effect is of very little significance. The 1951 law recognized some form of non-mandatory auditing called shareholder auditing “Accionistas Censores de Cuentas”. Under this type of audit, shareholders whose accumulated shares represent ten percent of the company’s capital stock may request for an auditor’s appointment.¹¹³⁴

When so appointed, the auditors would ascertain the reliability of the company’s annual financial statements. However, their capacity to meet that goal has been curtailed by the law itself. The law had empowered the directors of a company to block auditors’ access to financial records when they feel that their company’s interest may be jeopardized.¹¹³⁵ Hence, the work of the auditors was limited to reviews of the company’s financial statements, with little investigation of the accuracy and compatibility of the company’s supporting records and documentation.¹¹³⁶

¹¹²⁹ Id.

¹¹³⁰ CAÑIBANO L. & UCIEDA J. L., “Accounting and Financial Reporting in Spain”, 2005, p. 2, accessed June 6, 2013 at: www.uam.es/...pdi/.../canibano_ucieda_2005.pdf

¹¹³¹ GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., p. 306.

¹¹³² Id. See also RUIZ-BARBADILLO, E., ET AL., *Auditors versus Third Parties...*, op. cit., p. 122. The absence of legislation of such nature then may be attributed to the fact that most private companies in Spain were small and family owned.

¹¹³³ The law covers regulation of public companies.

¹¹³⁴ GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., p. 306. For more on audit regulation in Spain, see GONZALO ANGULO, J. A., & GALLIZO, J. L., *European Financial Reporting-Spain*, London: Routledge, 1992.

¹¹³⁵ Id.

¹¹³⁶ Id.

The driving force behind the rise and influence of audit in Spain did not come from legislation. It came from commercial and economic expansion taking place in Spain at the time.¹¹³⁷ As result, the Spanish government embarked on a series of reforms to its financial market aimed at updating Spanish regulations to cope with the fast growing capital markets activities in the kingdom.¹¹³⁸ These reforms involved enforcing the audits of financial statements of inter alia, state monopolies, regulated industries, such as banks, and utility companies, like electricity.¹¹³⁹ The enactment of the audit law in 1988 further strengthened these reforms. As noted by Carlos SOLCHAGA CATALÁN, Minister of Economy and Finance as he then was, when presenting the bill:

El proyecto de ley es cuidadoso, que constituye una pieza fundamental en la modernización de los hábitos financieros, contables y económicos de una sociedad que se está transformando muy rápidamente, como es la española y que, al mismo tiempo, se está abriendo a la economía internacional, con la cual debe compararse en sus (standard) de cualidad y de información.¹¹⁴⁰

The 1988 audit law,¹¹⁴¹ based on the Directive 84/253/ EEC, was a milestone in Spain's commercial and accounting history. It substantially transformed the way audit is organized and practiced in Spain, opened the Spanish economy to the world and brought the world to Spain. This much was also the conclusion of SALMON as reproduced below:

...the most important structural change in the Spanish economy during the 1980's was the further opening up of the economy to international trade and the avalanche of foreign inward investment occasioned by new legislation and membership of the European Community.¹¹⁴²

¹¹³⁷ Id at p. 307.

¹¹³⁸ Id.

¹¹³⁹ GABAS TRIGO, F. (1992) in GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., p. 306.

¹¹⁴⁰ See "Congreso de los Diputados, Diarios de Sesiones 84, p. 5361, 11 de febrero de 1988"

¹¹⁴¹ This is the main statute that regulates audit in Spain in conjunction with other laws "leyes", rules "reglamentos", royal decrees "reales decretos", orders "ordenes" and resolutions "resoluciones" of the ICAC.

¹¹⁴² SALMON, K. G. (1991, p. 17) in GARCÍA BENAÚ, M. A. & HUMPHREY, C., *Beyond the Audit Expectations Gap...*, op. cit., at p. 308.

The Audit Law established a combined system of public and private sector accounting regulation, namely, “Instituto de Contabilidad y Auditoría de Cuentas” Institute of Accounting in conjunction with Audit and professional auditors’ associations. According to RUIZ-BARBADILLO et al., “it is best to describe the system of audit regulation which was established in Spain as “mixed”. While the professional bodies were given a degree of flexibility, their operations were to be subject to the approval and oversight of ICAC.”¹¹⁴³

7.1 INSTITUTO DE CONTABILIDAD Y AUDITORÍA DE CUENTAS (ICAC)

The public sector control is exercised by the ICAC,¹¹⁴⁴ a body corporate constituted under section 56 LAC. The ICAC as a body is made up of three units, consisting of the chair, auditing committee and accounting board. The chair, who presides over the body, is appointed by the government on the recommendation of the Minister of Economy. Membership of the other units is drawn from a cross section of stakeholders and experts in the financial industry.¹¹⁴⁵

The ICAC acts as central authority responsible for inter alia, the regulation of accounting, the discipline of the audit profession and the inspection and control of audit quality.¹¹⁴⁶ The 1988 law introduced, for the first time, an Official Auditor’s Registry ROAC and placed it under the management of the ICAC.¹¹⁴⁷ It made audit of financial statements obligatory for medium and large limited companies¹¹⁴⁸ and also “laid down a model stipulating the responsibilities of the audit profession and the way in which it was to be regulated.”¹¹⁴⁹

¹¹⁴³ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 124.

¹¹⁴⁴ See articles 1 and 27 LAC. This law, originally “Ley 19/1988 de 12 de Julio de Auditoría de Cuentas”, has undergone many amendments to accommodate various Directives of the European Commission. It was lastly amended by “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas.” See also article 61 RAC.

¹¹⁴⁵ Articles 58.2 and 59.3 LAC.

¹¹⁴⁶ See articles 52 and 53 LAC, together with articles 61 to 77 RAC. See also RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 123.

¹¹⁴⁷ See articles 7, 8 and 27 LAC. Articles 9 and 41 of LAC accord auditors of European Union and other countries the opportunity to practice in Spain on grounds of reciprocity.

¹¹⁴⁸ With the exception of those companies that can present an abridged income statements

¹¹⁴⁹ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 122. Please see also section 263 of “Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital” (hereinafter LSC), and “Disposición Adicional Primera” of LAC and RAC.

The work of ICAC is duly complemented by associations representing auditors referred to as “public law bodies representing professional auditors” by the RD 1517/2011.¹¹⁵⁰ These are Register of Economist-Auditors “Registro de Economistas Auditores” (REA), General Register of Auditors “Registro General de Auditores” (REGA) and Spanish Institute of Chartered Accountants “Instituto de Auditores-Censores Jurados de Cuentas de España” (IACJCE). The Regulation embraced these associations by recognizing them under article 104 RAC;¹¹⁵¹ in fact many of the powers of ICAC are subsequently delegated to these professional associations.¹¹⁵²

The Audit Law introduced a new structure of specialization where, the professional associations were assigned the roles of drafting technical auditing standards, ensuring quality control, organizing continuous professional training, and organizing the mandatory examinations and control of practical experience required to enter the profession.¹¹⁵³ The “Asociación Española de Contabilidad y Administración de Empresas” (AECA) for example, has been at the forefront of standard setting in Spain. Its approach to standard setting has been a participative one, where a cross section of institutions involved in preparation, verification and use of financial statements are brought together to discuss their views.¹¹⁵⁴ In fact the AECA’s recommendations are commonly adopted by companies and frequently form the basis for subsequent official regulations from the ICAC. The ICAC, where necessary, may ask these professional bodies to elaborate, revise or adapt any technical rule or norm. If they fail to act accordingly after the expiration of six months, the ICAC will employ its power of last resort and proceed to adapt the said rule.¹¹⁵⁵ Thus, while the auditing associations were given some measure of independence in the conduct of their affairs, they are nonetheless subject to the control and oversight of ICAC.¹¹⁵⁶

¹¹⁵⁰ See article 104 RAC.

¹¹⁵¹ See also “Disposición Final Única” RAC.

¹¹⁵² Please see articles 24 and 27 LAC together with articles 21 and 105 RAC.

¹¹⁵³ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 124.

¹¹⁵⁴ CAÑIBANO L. & UCIEDA J. L., Accounting and Financial..., op. cit., p. 11.

¹¹⁵⁵ See articles 27 LAC and 24 RAC.

¹¹⁵⁶ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 124.

7.2 COMISIÓN NACIONAL DEL MERCADO DE VALORES

Another body engaged in financial regulation is the National Securities Market Commission “Comisión Nacional del Mercado de Valores” (CNMV).¹¹⁵⁷ The CNMV is a body corporate established under section 13 of the Securities Market Law “Ley 24/1988, de 28 de julio, del Mercado de Valores.”¹¹⁵⁸ It is composed of a chair and vice chair that must be knowledgeable in the field of securities, and are to be appointed by the government on the recommendation of the Minister of economy and Finance. Other members are Director-General of the Treasury, Vice President of the Central Bank and three members to be nominated by the Minister of economy and Finance.¹¹⁵⁹

The CNMV has the mandate to oversee the activities of the Spanish stock Exchange and foster transparency and efficiency in the capital market. It also protects investors from unfair prices by promoting fair financial reporting, and generally, enforcing the provisions of the Spanish security law.¹¹⁶⁰

8. AUDITOR LIABILITY CAMPAIGNS IN THE POST-ENRON CLIMATE

For a long time, liability of external auditors has been regarded as one of the tools the SEC uses to put auditors their toes as well as increase investor confidence, but this is not without costs. While auditors were faced with liability problem even before the advent SOX, the requirement under SOX for auditors to attest to the validity of the statements provided by their clients has also increased the liabilities that auditors face.¹¹⁶¹ Apart from threat of sanction by the SEC, liability they face from clients, and especially third parties, are a means of ensuring that auditors are vigilant and accurate in their review of financial statements.¹¹⁶²

The magnitude of liability faced by auditors after coming into effect of SOX can be seen in some notable lawsuits brought against auditors. For instance, in the first quarter of 2008, the firm PricewaterhouseCoopers (PwC) was forced to settle three lawsuits

¹¹⁵⁷ Article 84 LMV.

¹¹⁵⁸ This Law was amended by “Ley 37/1998, de 16 de noviembre, de reforma de la Ley 24/1988, de 28 de julio, del Mercado de Valores.”

¹¹⁵⁹ Article 17 LMV.

¹¹⁶⁰ Articles 13 and 14 LMV, for more on Spanish accounting regulation please refer to CAÑIBANO L. & UCIEDA J. L., *Accounting and Financial...*, supra.

¹¹⁶¹ SPELL, S. M., *Capping Auditor Liability...*, op. cit., p. 337.

¹¹⁶² Id.

brought against it, to wit: “Metropolitan Mortgage and SmarTalk Teleservices each for about \$30 million, and Crocus venture capital, for \$6.1 million.”¹¹⁶³ In a similar development, in 2005 Deloitte settled with Fortress Re. for \$250; PwC had to settle a suit with the shareholders of Tyco shareholders to the tune of \$225 million in July of 2007; Arthur Andersen was forced to settle out of with Baptist Fund of Arizona for \$217 million in 2002; and in another case with Adelphia in 2006, Deloitte settled for \$210 million. Meanwhile, these are only some few representative sample of the liabilities that auditors have recently faced.¹¹⁶⁴

Another case in point is the large settlement reached in a suit between the shareholders of Rite-Aid Corporation (Rite-Aid) and KPMG. KPMG agreed to pay \$125 million to the shareholders as part of the Stipulation of Settlement. The shareholders allege that KPMG has failed to adequately audit 1999 restatement of Rite-Aid’s earning which was later proved to contain fraudulent information. The importance of this case lies in the fact that there is evidence to the effect that KPMG itself was a possible victim, like the shareholders, of a systemic fraud. The fact that KPMG resolved to settle the case shows the liability apprehensiveness of auditors.¹¹⁶⁵

According to SPELL, “this is the exact type of fraud and oversight that the SEC, through SOX, has been attempting to prevent. The immense legal liabilities that auditors face exist because it is necessary to hold them liable in order to increase investor confidence. To cap liability when mistakes like this are still occurring is simply giving auditors a license to be less careful.”¹¹⁶⁶

The above cases are a testament to the liability problem faced by auditors but none is more obvious and notorious to the liability threat posed to auditors than the sudden demise of Arthur Andersen. As seen in Chapter IV, Arthur Andersen was at the time of its fall the fifth largest accounting firm in the world, and Enron’s accounting firm since the inception of Enron.¹¹⁶⁷ Although their appeal against liability in the Enron scandal succeeded at the Supreme Court in 2005, and led to the dismissal of the case, the Enron

¹¹⁶³ Id (citing TELBERG, R., “Top 10 Auditor Liability Settlements”, *C.P.A. TRENDLINES*, Apr. 15, 2008, <http://cpatrendlines.com/2008/04/15/top-10-auditor-liability-settlements/>.)

¹¹⁶⁴ Id.

¹¹⁶⁵ Id at p. 338.

¹¹⁶⁶ Id.

¹¹⁶⁷ Id at p. 339.

scandal was so huge on the firm's reputation that it could not survive.¹¹⁶⁸ At the end of the day the most important asset any audit firm could have is its reputation. In the wake of the Enron scandal Arthur Andersen's lost the bulk of its clients for its inability to serve its gatekeeper role in Enron. Loss of clients and reputation coupled with its liabilities, eventually led to the firm's collapse.¹¹⁶⁹

With the final collapse of Arthur Andersen, the auditing profession was faced with a grim fact that the failure of yet another firm is not an unforeseeable possibility. This prospect sparked yet another push towards restricting the liability faced by auditing firms. According to Spell, "auditors argue that there is a definite risk that more firms could implode in the near future in light of the liabilities that accounting firms face."¹¹⁷⁰ This fear is justified by two important events, as recounted by BUSH et al, in one "case of alleged criminal behavior of KPMG in the US with respect to fraudulent tax advice, the US Justice department chose to settle for a \$456 million fine on the firm and action against the individuals involved, instead of disbarring the firm from performing audits of publicly held firms (U.S. Department of Justice, 05-433, August 29, 2005)."¹¹⁷¹ Another case was the "claim of £2.6 billion was made against Ernst & Young in the UK in the Equitable Life case. Although the claim was dropped, had it succeeded at considerably lower damages, the firm could have been seriously weakened in the UK."¹¹⁷²

The arguments across auditor's circles for liability caps revolve around the same shared concerns. "The fear is that the liability that auditors currently face could result in the collapse of another major auditing firm. The auditing profession lobby argues that while the role of private litigation is important in capital markets, there should be "concern over rising litigation costs, 'mega' suits, and pressure on audit firms to settle cases instead of litigating them." Various actors have "moved in numerous ways to place enhanced scrutiny on the financial reporting and controls practices within publicly

¹¹⁶⁸ Supreme Court of the United States reversed Andersen's conviction because of flaws in the jury instruction. The court is of the view that the instructions were worded in a manner to convict Andersen anyway even without any proof that the firm knew it had broken the law.

¹¹⁶⁹ SPELL, S. M., *Capping Auditor Liability...*, op. cit., p. 339.

¹¹⁷⁰ Id.

¹¹⁷¹ BUSH, T., ET AL., *Auditor Liability Reforms...*, op. cit., p. 13

¹¹⁷² Id. All efforts by auditors to obtain insurance for these liabilities have been fruitless. Meanwhile, their attempt on "self-insurance through wholly owned insurance companies is not clear [whether] it will be sufficient to protect auditors." SPELL, S. M., *Capping Auditor Liability...*, op. cit., p. 339.

traded firms. Amid this flurry of activity . . . [a]uditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the . . . viability of the industry as we know it.”¹¹⁷³ But, what would happen if auditors were freed from the fear of liability for audit failure? SPELL retorts as follows:

However, the increased liability auditors now complain of is the precise liability we want them to face. “The tort system is designed to create incentives for auditors to take appropriate actions to minimize the issuance of misleading financial statements and to compensate for their recoverable losses” should the auditor fail to properly perform its duties. Removing potential liability will not further the goal of increasing investor confidence through valid and thorough information, as the very mechanism designed to ensure accuracy will be largely diminished.¹¹⁷⁴

SPELL further argues that “[w]hile shareholders bringing federal securities class actions are understandably a potential cause of the demise of one of the Big Four auditors; there are other liabilities that auditors face in relation to their role as gatekeepers. An auditor could potentially implode as a result of losing its ability to practice following criminal sanctions. Money sanctions and penalizations imposed in both civil and criminal litigation could also bring about the potential collapse of an accounting firm. And finally, auditors face the threat of federal securities class action lawsuits—the impetus behind the efforts to cap liability.”¹¹⁷⁵

On the face of above arguments on liability and a supposed implosion threat that would create an unacceptably uncompetitive environment with only two or three large firms, “the Big Four accounting firms have decided to lobby for a cap on the potential liabilities they could face, and have also attempted to use contractual clauses to shield themselves. The Big Four are asking the firms they audit to limit their right to sue, and to waive their right to punitive damages. While this will only cap corporations’ ability to sue, it does have the potential to save the accounting firms the large sums of money they are forced to pay to the corporations. Even though auditors will still face liability to

¹¹⁷³ SPELL, S. M., *Capping Auditor Liability*..., op. cit., p. 339-40 (citing TALLEY, E. L., 2006).

¹¹⁷⁴ Id.

¹¹⁷⁵ Id at p. 340.

the shareholders that bring federal securities class actions, the agreements attempt to bar derivative suits. Various complaints have been made by investors who argue that these agreements may violate SEC rules, and that the provisions overall are too self-interested and against the SEC principle of putting the investor first. Auditors have also attempted to further alter their liability, without government assistance, through contract law, by including arbitration clauses, indemnity and hold harmless provisions, and other similar protections in their dealings with clients.”¹¹⁷⁶

They further contend that while the sheer numbers of securities class action suits filed against the major accounting firms have considerably dwindled, due largely to the effect of (PSLRA), the risk of catastrophic liability in any one of the remaining four accounting firms is enormous.¹¹⁷⁷ The example of Arthur Andersen’s demise following the collapse of Enron Corporation still serves as an objective lesson to all that a single exposure can lead to the ruin of any one firm. However, the politics of catastrophe embarked upon by the audit profession have led to suspicion in some quarters, with politicians and regulators saying that the risks to major accounting firms are overblown, or perhaps even fictitious.¹¹⁷⁸

This criticism may be justified by the profession’s submission in support of liability before the US senate where they overstated the case.¹¹⁷⁹ They claimed that their litigation cost estimate for the year 1992 was 14 percent of their total revenue. This figure however, included a 400 million settlement by Ernst & Young. It is noteworthy that US case law had already established that an auditor could only be found guilty if his conduct was reckless, i.e. something more than negligence.¹¹⁸⁰ According to SLAVIN,¹¹⁸¹ acts of negligence can no longer impose statutory liability to third parties under *SEC Rule 10.5b*. Furthermore it was held in the case of *Central Bank of Denver v. First Interstate Bank*¹¹⁸² that ‘aiding and abetting a fraud could not subject the auditor to

¹¹⁷⁶ Id.

¹¹⁷⁷ PEARSON, T. C. & MARK, G., *Investigations, Inspections...*, op. cit., p. 51.

¹¹⁷⁸ So did other commentators like spell who argues that liability caps could only serve as recipes for less audit quality. See SPELL, S. M., *Capping Auditor Liability...*, op. cit., p. 337.

¹¹⁷⁹ BRILOFF, A. J., “The Private Securities Litigation Reform from a Critical Accountant’s Perspective”, *Critical Perspectives in Accounting* 10, 1999, p. 270.

¹¹⁸⁰ *Hochfelder v. Ernst & Ernst* (425 US. 185 1976)

¹¹⁸¹ See generally, SLAVIN, N. S., “The Elimination of “Scienter” in Determining the Auditors’ Statutory Liability”, *The Accounting Review*, 1977, 52. pp. 360-368

¹¹⁸² US. 16, 1994.

legal liability.’ Hence, it was argued that auditors were quite protected under the existing regime.

8.1 THE BURDEN OF LIABILITY IN SPAIN

Although Spain may be less litigious than the US and some other Western democracies, the risk of regulatory sanction is not a negligible cause of concern for auditors. Auditors are subject to sanctions by the ICAC if they fail to detect and report fraudulent financial reporting.¹¹⁸³ These sanctions can be quite severe, including the withdrawal or suspension of practicing licenses, admonishment, and monetary fines.¹¹⁸⁴ Meanwhile, it is the exercise of this power by ICAC that has proved especially controversial in Spain and have been a significant trigger for comments and actions on the part of leading representatives of the accounting profession. GARCÍA BENAÚ et al.¹¹⁸⁵ provide evidence that the existence of an independent regulatory body was never popular among the Spanish accounting profession when Spain was adapting to the EU Company Directives.¹¹⁸⁶ Legal writings in Spain have continued to bear that fact. For example, in an article “All against one and one against all”, OREGUI,¹¹⁸⁷ rightly captured the views of the leading members of the profession on ICAC, as is illustrated in the following comments attributed to José Luis DíEZ, the president of REA:

The sanction regime is totally unjust. It puts us at the feet of whichever person demands civil responsibilities. Almost all the proceedings are based on professional judgments. Why are the criteria of ICAC going to be better than those of auditors who are making such judgments day to day?¹¹⁸⁸

Amid these comments, came the inevitable calls for reduction in auditors’ liability exposure drawing from trends taking place in the global arena. As profoundly advocated by Tomás FERNÁNDEZ DE PINEDO of PriceWaterhouse:

¹¹⁸³ Articles 68 and 70 LAC.

¹¹⁸⁴ Article 75 LAC.

¹¹⁸⁵ GARCIA BENAÚ, M. A., ET AL., *Success in Failure...*, op. cit., p. 713.

¹¹⁸⁶ Id. In fact, some of the leadership of auditing professional associations backed by the spokespersons of Price Waterhouse and Coopers & Lybrand, embarked on an initiative to challenge the ICAC’s right to sanction audit firms. They argued that the right of sanction should only be exercised by the court not the ICAC. (see *Expansión*, 20/6/95, p. 35).

¹¹⁸⁷ OREGUI, P., “Todos contra uno y uno contra todos”, *El País, Negocios*, July 28, 1996, pp. 2-3, in GARCIA BENAÚ, M. A., ET AL., *Success in Failure...*, op. cit., p. 713.

¹¹⁸⁸ Id (quoted from OREGUI, P., 1992, p. 2).

In terms of the contractual responsibility of the auditor towards the company that solicits its services, it is ridiculous to think that it can be unlimited. As happens in other countries such as Germany, Austria and Greece, one ought to impose a law, a maximum sanction, for example between three and four times the audit fee. On the other hand, it is unthinkable to think that bad managers cause the same damage as auditors. In case of negligence on the part of both, one should first demand responsibility from the management and then the auditors, but only for the part corresponding to them. . . . As to extra-contractual responsibility to third parties, the law doesn't say anything. It is necessary to interpret who has the right and who is authorized to hold auditors responsible. From my point of view, as it is the company who contracts with the auditor through its board of directors, only it can demand responsibility and not shareholders, one by one, individually.¹¹⁸⁹

One intriguing thing to note from the above quote is the fact that, third party liability claims cannot be said to be a burden on the Spanish audit market by all shades of imagination. This observation most certainly brings into context the concerns expressed by HOPWOOD on the international outreach of the lobbying power of the accounting profession:

Agents of the international audit industry are amongst the most prolific conveyors of our present knowledge of and literature on questions of supranational and international accounting policy. They seemingly exert a significant influence over the discursive representation of the area and the forms in which options and debates are cast. The prevailing understandings are therefore in danger of being derivative from the processes of policy making themselves rather than offering a more independent means for reflecting upon them.¹¹⁹⁰

The voice for reform within the accounting profession itself has not been unanimous. There were views that still sympathize with the Spanish legal tradition of individual

¹¹⁸⁹ Id at p. 715 (quoted from OREGUI, P., 1992, p. 3).

¹¹⁹⁰ Id (quoted from HOOPWOOD, A., 1994, p. 247).

responsibility. But for how long it will last is entirely anyone's guess. Ricardo BOLUFER represented such a view:

Whichever new law is applied it ought to maintain the civil responsibility of auditors to third parties. If one changes this principle, what sense would there be in the situation of having publicly available audited accounts but with no third party being able to claim against them?¹¹⁹¹

8.2 AUDIT LIABILITY REFORM PROPOSALS IN THE US

There have been several proposals in the U.S aimed at protecting the accounting profession from the so called liability catastrophe. The following is an overview the important ones.

8.2.1 THE PAULSON COMMITTEE REPORT

This committee was so referred because it was created at the behest of U.S. Treasury Secretary Henry PAULSON. Its history began in November 2006, with the release of a preliminary report by the Committee on Capital Markets Regulation. The Committee was led by Hal SCOTT, a Harvard law professor, Glenn HUBBARD, the dean of Columbia's business school, and John L. THORNTON, a former president of *Goldman Sachs* and the incumbent chairman of the Brookings Institution. The Committee issued its "*Interim Report of the Committee on Capital Markets Regulation*" in order to address various challenges facing the U.S. capital markets, and to propose regulatory and market reforms directed to those challenges. The Committee's Interim Report concluded that the competitiveness of U.S. capital markets was declining, a development the committee attributed in part to the comparatively high costs of U.S. regulatory compliance and litigation risk. Among other things, the committee recommended that Congress explore options for protecting auditors from catastrophic liability.¹¹⁹²

The Interim Report discussed the increasing liability risks posed to the remaining Big Four accounting firms, and the possible impairment of consumer choice if one of those

¹¹⁹¹ Id (quoted from OREGUI, P., 1996, p. 3).

¹¹⁹² DICKEY, J. C., WU, A. & WALLIN R., "2008 Securities Litigation Reform Forecast: Cloudy, Chance of Rain", Securities Litigation Report, 5, 2008, p. 4.

firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. ‘For the profession itself, there is consensus both inside and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders,’¹¹⁹³ the report stated. In light of these concerns, the Interim Report included several proposed reforms addressing the issue of auditor liability:

- a. Create a safe harbor for certain defined auditing practices;
- b. Set a cap on auditor liability in certain circumstances;
- c. Grant regulators specific powers to appoint “monitors” to oversee operations of audit firms found to have engaged in systemic failures in process, management or personnel;
- d. Clarify and limit an auditor’s duties under Section 10A; and
- e. Restrict criminal indictments against firms, as opposed to individual audit partners.

Following release of the *Interim Report*, the U.S. Treasury Department announced on May 17, 2007 that it was appointing a “*Treasury Advisory Committee on the Auditing Profession*,” headed by Arthur LEVITT, former Chairman of the Securities and Exchange Commission (SEC) and former SEC Chief Accountant Donald NICOLAISEN, to consider possible reforms relating to the accounting profession.

On Sept. 26, the Advisory Committee released a draft of its final report. The report succinctly stated that “no audit firm is too big to fail,” and that any such failure would have “systemic repercussions throughout the global capital markets.” Nevertheless, the Committee could not reach a consensus recommendation on private litigation. The

¹¹⁹³ Interim Report of the Committee on Capital Markets Regulation, p. 87.

Committee acknowledged, however, that it is “desirable to continue that debate,” and that “policy makers and the legal system should consider progressively moving towards a structure that at least for the most part embodies a common national set of standards,” and perhaps a “national professional liability regime for public company auditing firms.” The Committee also observed that “Congress may in fact wish to consider creation of a federally chartered audit structure for firms which choose to operate as such.” Within such a structure, the Committee states, one characteristic might be “limits of liability for audits of public companies.”

Unsurprisingly, after almost two years of work, the Paulson Committee’s “non-recommendations” were not satisfying to some of the participants in that effort. Former SEC Chief Accountant Lynn TURNER, who was the sole dissenter on the Committee’s 14-1 vote to approve the final report, was more vocal, saying that it might have been better for the audit profession if the Committee had simply left the issue of catastrophic liability unaddressed in the final report. “Right now, I don’t see any chance whatsoever of any litigation reform in light of what happened with this group,” Turner is quoted as saying.¹¹⁹⁴ The head of the Center for Audit Quality, Cynthia FORNELLI, who had strongly advocated that the Committee should address the issue of catastrophic liability “comprehensively,” was more hopeful, saying that “we encourage those in the policymaking community to use this report’s acknowledgement of catastrophic liability as a starting point for further examination of the issue.”¹¹⁹⁵

8.2.2 THE BLOOMBERG-SCHUMER REPORT

This is another important report with same term of reference. It was issued in early 2007 by *New York City Mayor* MICHAEL R. BLOOMBERG and *Senator* CHARLES E. SCHUMER (D-N.Y.). The comprehensive report was entitled “*Sustaining New York’s and the US’ Global Financial Services Leadership*.” The *Bloomberg-Schumer Report* made a number of recommendations to increase the competitiveness of the U.S. capital markets, a few of which are pertinent to the protection of audit firms, echoing the *Paulson Committee report*. The Specific *Bloomberg-Schumer report* proposals are reproduced here below:

¹¹⁹⁴ Treasury Committee’s Report Missed Huge Opportunity for Litigation Reform (BNA Corporate Accountability Report, October 31, 2008).

¹¹⁹⁵ Id.

The rising cost of the US legal system is well-documented and extends far beyond financial services and the scope of this report. Any comprehensive legal reform effort would require long-term energy and attention by policy makers at the highest level, as well as significant legislative change. It would also require careful balancing of the respective interests of investors, consumers, businesses, and other parties. The outcome of any legal reform should not be to undermine the ability of plaintiffs with valid claims to recover appropriate damages. Instead, such reform should seek to eliminate those suits filed to pressure companies into settlement rather than to redress legitimate wrongs, as these suits dampen the business environment without providing a commensurate social benefit.

While it is clear that coordinated legislative and enforcement-level efforts will be required to bring about many of the desired improvements in the legal environment surrounding financial services, regulatory agencies are well positioned to have a positive impact in the near-term. The SEC, in particular, has broad powers that it could proactively use to deter the most problematic securities-related suits. For example, Section 36 of the Securities Exchange Act of 1934 effectively allows the SEC to conditionally or unconditionally exempt persons or transactions from most provisions of the Act, so long as doing so is in the public interest and consistent with investor protection requirements. In using Section 36 to improve market conditions for both companies and investors, the SEC would merely be invoking authority that Congress has already bestowed upon it. Furthermore, the agency would be doing so within a clear statutory cost/benefit framework, in harmony with the principles of good regulation proposed in Recommendation 3 below, and with investor protection remaining a paramount consideration.

Among proactive enforcement strategies that regulators could consider, pursuant to a thorough cost/benefit analysis, as they seek to improve the legal climate in the securities industry, three in particular need to be considered. First, limiting the liability of foreign companies with US listings to securities-related damages that are proportional to their degree of exposure to the US markets would serve to more adequately align the costs and benefits to foreign issuers of a US listing.

Second, imposing a cap on auditors' damages for securities-related infractions that is sufficient to deter wrongdoing in accounting would also lessen unnecessary and costly risk-averse behavior on the part of auditing firms. It would do so by making auditing firms once again insurable, which would have the added benefit of reducing the likelihood that the highly concentrated US auditing industry will lose another major player. Finally, granting smaller public companies the ability to "opt-out" of particularly onerous regulatory requirements, provided that they conspicuously disclose the fact to investors and assuming the SEC is satisfied that shareholders will remain adequately protected, would help increase the appeal of a US listing to small companies both domestically and abroad.

8.2.3 COMMISSION ON REGULATION OF THE U.S. CAPITAL MARKETS

This committee's report came out in March 2007 and recommended several broad litigation reforms, and specifically called upon the SEC to undertake a thorough review of how the PSLRA has addressed the problem of frivolous shareholder litigation since its passage by Congress. This Commission recommended that domestic and international policy makers "seriously consider proposals ... to address the significant risks faced by the public audit profession from catastrophic litigation." Among other findings, the report stated that "sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets," and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.¹¹⁹⁶ Specific recommendations of the Commission include:

- a. Public companies, audit firms, the SEC, PCAOB, and other financial services regulators and policy-makers should take affirmative steps toward closing the "expectations gap"—that is, work to establish realistic public expectations about the degree of precision inherent in financial statements and constraints on those auditing these statements.

¹¹⁹⁶ Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007).

- b. The Department of Justice should revise the McNulty Memorandum to address the special considerations relating to the consequences of criminally indicting an audit firm (i.e., the overarching public policy concern that a criminal indictment of a Big Four firm would have severe consequences for public company clients of that firm and for the U.S. economy).
- c. The Commission recognizes that addressing the risk of catastrophic loss is complicated and that many of the proposals offered are politically charged. Given the significant public policy ramifications in the event of a catastrophic loss of a large public company audit firm, the Commission calls on domestic and international market participants and policymakers to engage immediately in a serious evaluation and discussion of possible means to address this risk of catastrophic loss, including this Commission's recommendation regarding backup insurance sponsored by G-8 governments or international financial organizations, and various proposals of others regarding safe harbors or damage limits in specified circumstances.
- d. The SEC should work with the U.S. Department of the Treasury to place the issue of developing a framework for support of multinational accounting firms on the agenda of the G-8. This framework could take many forms, including backup insurance sponsored by G-8 countries or international financial organizations.
- e. Congress should consider enacting legislation to create the option of a federal charter for no more than 10 to 15 of the largest national audit firms, which would include the ability of audit firms with federal charters to raise capital from shareholders other than audit partners of such firms (subject to addressing relevant concerns about audit independence and potential conflicts of interest).

The Commission is also of a considered view “that audit firms and their clients should be encouraged to explore arbitration and other alternative dispute resolution (ADR) agreements as a way of managing the costs of civil liability and audit practice

protection. Both parties to these agreements can benefit from the decrease in possible future litigation cost.”¹¹⁹⁷

In the end, despite the constructive debate and proposals that the issue of auditor liability has generated over the years, there seem to be no clear consensus reached on the best way to tackle it. All of the above commissions have in some way expressed concern about liability and litigation cost, which may overwhelm auditors and ultimately push them out of business. They have also acknowledged the important of litigation as a driver of quality in the capital markets. The push and the debate of its appropriateness still continue in the US.

9. SPAIN: IN PURSUIT OF LIABILITY REFORMS

Over the years, relations between the socialist government and the auditing profession have deteriorated due to what the auditors came to regard as an interventionist attitude of the ICAC. In particular, the sanction imposed by the ICAC on a number of firms in the follow up to the Banesto financial scandal.¹¹⁹⁸ So when the socialist government was defeated in the 1996 general elections by the conservative, “Partido Popular” (PP), the audit profession saw a great opportunity to launch its campaign for reform in the audit law. The entrant government is known for its pro-market stance as evidenced in its support for self-regulated auditing profession in the parliamentary debates on the 1988 Audit Law.

The new government quickly moved to improve relations with the audit profession and to implement some changes earlier requested of the socialist government by the profession to no avail, like the non-publication of sanctions in the *official bulletin* (BOICAC). Whereas the new government was inclined to the changes being proposed by the accounting profession and is intent in reviewing the 1988 audit law, it first wants to see a more unified accounting profession. These changes included the introduction of a self-regulatory regime and the reductions in auditors’ liability. This condition set out by the government and the great prospect that it represented for the profession propelled

¹¹⁹⁷ Id.

¹¹⁹⁸ The sanction was to the tune of Pta. 595mn across a wide range of auditing firms – see *Expansión*, 10/9/96, p.36.

the professional bodies to close ranks, including the talks of unification. But it was in the area of auditor liability that the profession has demonstrated that it most keenly wants a reform.

Pursuant to the above, the accounting profession commissioned PANTALEÓN, a prominent civil law professor to review the civil liability of auditors drawing from state of the law in other countries like Germany and the UK. According to the learned author the reading of the 1988 Audit Law permits placing liability limits clauses on auditors' liability.¹¹⁹⁹ With regard to third party liability, he reviewed the position in Germany, UK and US, and strengthened by the decisions in *Caparo Industries Plc v. Dickman and others* and *Bily v. Arthur Andersen*, he concluded citing with approval the celebrated dictum of CARDOZO J. in *Ultramares Corp. v. Niven & Co.* case:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to liability in an indeterminate amount for an indeterminate time, to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may to exist in the implication of a duty that exposes to these consequences.¹²⁰⁰

However, when finally a change was proposed to articles 11 and 12 of the 1988 Audit Law,¹²⁰¹ the parliament rejected it preferring instead to a global reform of the law. But this did not deter the quest for change. Thus in 1997 the ICJCE prepared and published a White book, which contained articles by some professors, important politicians and an auditor. But most significantly, a section in it was dedicated to promoting the ICJCE's policy. This section called for fundamental changes to existing auditing legislation. These included the:

1. need for a more precise definition of the auditor's responsibility to third parties;

¹¹⁹⁹ PANTALEÓN F. (1996, p. 9) in RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 130.

¹²⁰⁰ 174 N.E. 441 (1932) at p. 444.

¹²⁰¹ Now article 26 under the new Audit Law of 2015

2. substitution of the current system of limitless auditor responsibility to one proportional to the damage caused by any negligent audit work (subject to an absolute limit being placed on any such damage claim;¹²⁰² and
3. establishment of a maximum term beyond which no claim against auditors would be permissible.¹²⁰³

Writing in the *White Book*, PANTALEÓN reiterated his stance on limitation of auditors' liability. He went further to draft two new clauses to replace articles 11 and 12 of the 1988 Audit Law.¹²⁰⁴ Other expert contributors to the White Book also tilted toward reduction in audit liability. The only dissenting view came from FERNÁNDEZ-ARNESTO, the President of the Spanish Stock Exchange Commission "Comisión Nacional del Mercado de Valores",¹²⁰⁵ who was opposed to any reform which sought to treat auditors in a privileged manner in comparison with other professional groups. He stressed that Spain was at the very beginnings of audit experiment and should not be compared with much experienced countries like the USA and that the imposition of a liability cap, as in Germany, was not an attractive solution:

I see no reason in the Spanish legal context for auditors to be the only professionals able to enjoy an exceptional and privileged responsibility regime. Furthermore, to limit responsibility is a measure that goes radically against the evolutionary tendencies of our mercantile law, and could be a measure that undermines the confidence of the public in the value of the audit report. Don't forget that the audit is a transaction cost like any other and can only be justified in the sense that the protection given to investors and creditors represents greater value than the audit fee. If such confidence reduces, people will increasingly connect the audit with other professional costs which could be sacrificed in the pursuit of better efficiency.¹²⁰⁶

¹²⁰² One contributor suggested a limit of Pta. 50 million.

¹²⁰³ Instituto de Censores Jurados de Cuentas de España (1997), *Libro Blanco de la Auditoría de Cuentas en España*, Madrid: pp. 252-4.

¹²⁰⁴ PANTALEÓN, F., Responsabilidad civil. Propuestas urgentes de reforma de la Ley de Auditoría de Cuentas, Ponencia presentada al XI Congreso de Censores Jurados de Cuentas de España, ICJCE, 1997, pp. 41-49. Now article 26 LAC.

¹²⁰⁵ RUIZ-BARBADILLO, E., ET AL., *Auditors versus Third Parties...*, op. cit., p. 132.

¹²⁰⁶ *Libro Blanco de la Auditoría de Cuentas en España*, Madrid: pp. 223-4.

The White Book in its conclusion emphasized once again the core issues in the reform debate, the importance of unifying the accounting profession; introduction of self-regulatory regime; sanction regime of the ICAC; and reduction in audit liability as crucial in any future legislative reform.

Contrary to the vast majority impression given in the *White Book*, the result of a commissioned market research detailed in the *White Book* itself showed that the majority of the respondent auditors were much more preoccupied with the vaunted ‘interventionist’ regulatory regime of ICAC than with audit liability reform.¹²⁰⁷

The liability campaign motives on the part of the profession’s leaders that informed the *White Book* was manifested in the contrast between the empirical findings and the alarmist general tone of the *White Book*. According to GARCÍA BÉNAU et al., the *White Book* was selective in its use of references, in that some articles in its bibliography that blamed the profession for the rise of audit expectation gap in Spain and another that criticized the manner they responded to major audit failures were not cited anywhere, or were the issues they raised countered in the development of the proposals put forward by the Book. The Book seemed more intent on establishing a case for liability reduction than debating the issues advanced by those articles. As reflected by GARCÍA BÉNAU et al:

In line with this intention, PANTALEÓN’s work on auditor liability (paid for and promoted by the profession and clearly central to its policy determinations) took a very selective view of the auditor’s responsibility to third parties. While PANTALEÓN provided an extensive review of the then current legal position in different countries, he devoted limited attention to the reasoning underlying some of the earlier case law. This had taken a more open view of the extent of an auditor’s liability to third parties, exemplified by the judgments in cases such as *J.E.B. Fasteners v. Marks, Bloom & Co.* (1981), *Twomax v Dickson, McFarlane & Robinson* (1982) or *Rosenblum, Inc. v Adler* (1983). PANTALEÓN also

¹²⁰⁷ In fact only 9% of the respondent thought the need to change the legal definition of auditors’ responsibility was necessary. See p. 305

presented the case law position in more fixed and determined terms than reviews of its status in the USA or the UK tend to suggest...¹²⁰⁸

Finally, the reform that the *White Book* sought to inspire failed to materialize. In what many believed to be the government's dissatisfaction with the profession for its failure to unite. Moreover, the government thought it wise to wait to the end of the European Union consultation period on the *Green Paper*.¹²⁰⁹

Despite the initial lack of progress as seen above, the reform campaigns continued, albeit with a renewed strategy. This time the profession embarked on organizing special conferences involving politicians from the governing, conservative party PP and the Basque Nationalist Party "Partido Nacionalista Vasco" (PNV) who were called to make presentation. A rare occurrence in the past, together with press interviews essentially preparing the stage for the reform agenda.

Their effort began to yield fruits when in May 1998 the *Basque party* presented a proposition in Parliament "Congreso de los Diputados" for a review and modification of the 1988 Audit Law. The review was to examine the audit function in Spain, and also take cognizance of the EU's recent Green Paper on the future of auditing profession. Then in June 1998 came the groundbreaking judgment on auditor's liability, the first in Spain, when a lower Spanish court ("un juzgado de primera instancia") found against *Ernst & Young* for its audit of "Promoción Social de Viviendas" (PSV), and ruled in favor of the demand brought by the partners of this housing cooperative.¹²¹⁰ The court found adequate evidence of a causal relationship between the negligent behavior of the auditor and the losses suffered by the partners of PSV and duly ordered *Ernst & Young* to pay Pta 2,300mn in damages.¹²¹¹ In arriving at this decision, the court reiterated the basic principles of the Spanish civil code (negligence, damage and a causal relationship between the two), and held that the literal reading of article 1902 of the Civil Code is clear as to the responsibility an auditor has not only to the audited company but to third parties as well. The court deliberately referred to PANTALEÓN's thesis and his support

¹²⁰⁸ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 134.

¹²⁰⁹ Id.

¹²¹⁰ The auditor's contract was with the co-operative itself, with the court determining that the partners had the status of a "third party".

¹²¹¹ RUIZ-BARBADILLO, E., ET AL., Auditors versus Third Parties..., op. cit., p. 134.

for the *Caparo*'s judgment – but held that this was not an adequate representation of the existing Spanish civil law.¹²¹²

The liability campaign push finally led to the establishment of a subcommittee by the Spanish Parliament to look into the possibility of modifying the 1988 Audit Law. The subcommittee got on to work, holding a public session, at which the three professional associations together with the ICAC were heard making their presentations. At the beginning of his presentation the president of REA, announced to the delight of members of the subcommittee the agreement reached by the professional bodies on presenting a unified proposal on the anticipated audit legislation reform. Although the agreement was confirmed by the other presidents, the transcripts of their various presentations revealed some areas of differences.

Each President presented the position of his association ranging from the existence of an audit expectations gap; damaging implications of various financial scandals; litigation crisis; loss of professional reputation being caused by an inadequately specified auditing legislation,¹²¹³ to the necessity of unifying of the three professional bodies, improving access to the profession, changing the rules governing independence and other ethical matters, and developing the profession's disciplinary powers and its capacity to control audit quality and quality control. One area where all the three bodies were all in agreement was on the need to limit the civil liability of auditors.¹²¹⁴

The President of REA (Registro de Economistas) in his presentation noted that the liability of auditors did not reflect their level of blame and concluded in the following terms:

We suggest that one should introduce the recommendations that you already know about on this matter, having been exposed to them in a multitude of public and private functions ... to limit, but never eliminate, responsibility, to introduce

¹²¹² This finding and the judgment have been confirmed on appeal to the Spanish Supreme Court.

¹²¹³ RUIZ-BARBADILLO, E., ET AL., *Auditors versus Third Parties...*, op. cit., p. 136.

¹²¹⁴ Id.

proportional responsibility, demonstrate effective damage, fix legal ceilings as exists in some countries, define legitimate third parties, etc.¹²¹⁵

On his part, the President of ICJCE emphasized the need to develop the notion of proportionate liability in Spain, delimit the notion of third party which he claimed was abused in Spain and adopt the criteria obtained in other European countries.

In their discussions on auditors' liability, all the Presidents complained about the interventionist actions of the ICAC which they felt serves as a fodder for third party claims. However there was no recognition whatsoever of any responsibility on their part for the widening of audit expectation gap or was there any suggestion that the "crisis" facing the auditor was a result of poor quality audit work.

In the presentation of the head of ICAC, GÓMEZ CIRIA, a different version to the above claims was presented. He questioned the effectiveness of the existing regulatory procedures of the professional auditing bodies, noting that between 1997- 99, they had only detected one auditor failing to comply with existing auditing standards and guidelines. This compared with the fact that 45% of ICAC's quality control inspections had resulted in proceedings against the auditors concerned.¹²¹⁶ He further emphasized the fact that all sanctions issued by ICAC for breaches of auditing standards and guidelines had been vindicated and ratified on appeal.

The ICAC President found no reason for legal liability reform given the ongoing review undertaken by the European Commission regarding the possible harmonization of legislative requirements governing the auditing function in each Member State. He is also of the view that whatever audit reform is pursued must take into consideration not only the auditors' interest but that of interested third parties as well. He went on to stress that should Spain contemplate any changes in its laws, the underlying principle of the audit law must be preserved:

¹²¹⁵ Subcomisión del Congreso de los Diputados, (1999), Subcomisión para el Estudio de la Problemática de la Profesión de Auditor de Cuentas, Congreso de los Diputados, 14 Diciembre pp. 5-6.

¹²¹⁶ Subcomisión del Congreso de los Diputados, 1999, p. 38.

The work of the auditor produces effects on third parties and I cannot see singularities in the work of the auditor that can justify them having a responsibility different to any other professional. The responsibility of the auditor has to be unlimited and universal.¹²¹⁷

In the end, the committee could not complete its work and did not report its findings at the end of the Spanish legislature, which ended in March 2000. The subcommittee by Spanish law therefore expired with the Parliament. However it is pertinent to point out that finally the audit law suffered several amendments. The last being the newly passed “Ley 22/2015, de 20 de julio, de Auditoría de Cuentas” incorporating the provisions of Directive 2014/56/EU and Regulation (EU) No 537/2014.

10. GLOBAL DIMENSION OF THE LIABILITY CRISIS: LIABILITY LIMITATION CLAUSES

Over the years, the debate for reduction in auditors’ liability exposure has taken a global center stage, and was only reinforced by the large corporate fraud scandals in the beginning of the twenty-first century in Europe such as Ahold in Holland, Nordisk Fjer in Denmark, and Parmalat in Italy and the U.S. most famously, Enron.¹²¹⁸ This conspiracy of problems has caused great anxiety over the scope of auditor liability which led to declaration in some quarters, at various times, to ‘an epidemic of litigation’¹²¹⁹, an ‘outrageous level of current claims’¹²²⁰ and even a possibility that ‘many audit firms face the risk of Armageddon’.¹²²¹

This fear coupled with the common believe within the accounting profession that liability claims against them is disproportionate to their fair share of the blame led to the introduction of liability limitation clauses in audit contract by auditors to protect themselves. As indicated above, in the US, the profession had successfully lobbied and secured the passage of LLP. The British government also legislated for the LLP option

¹²¹⁷ Id at p. 45.

¹²¹⁸ SPELL, S. M., Capping Auditor Liability..., op. cit., p. 332.

¹²¹⁹ Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, Price Waterhouse, (1992, p. 19).

¹²²⁰ Institute of Chartered Accountants of Alberta (ICAA), (1995), Opportunity, equity and fairness, Edmonton: ICAA p.11.

¹²²¹ WARD, G., “Auditors’ Liability in the UK: The Case for Reform”, *Critical Perspectives on Accounting*, 10, 1999, p. 388.

in the *Limited Liability Partnership Act 2000*. In Spain liability limitation through contract is not a novelty.

The industry's concern for liability 'epidemic' was echoed through a number of pronouncements by influential professional bodies. In 1995, the International Federation of Accountants,¹²²² for instance, issued a report which presented results of a comprehensive survey involving member organizations in 36 nations. The report provided a summary of the members' views on the legal liability regimes adopted in their countries and used these to make a case for international regulatory action to establish clear and consistent limits on auditor liability.¹²²³ It was argued that in those countries with unlimited liability regimes, such as US or Australia, the public conceptions of the roles of an auditor were distorted and often unrealistic, fuelling excessive litigation activity against auditors. In contrast, limited liability environments maintained in other countries were seen to facilitate greater efficiency in auditors' work, while serving the public interest through rigid enforcement and compliance practices.¹²²⁴

11. DEVELOPMENTS IN THE EU

Although individual EU countries' positions vis-à-vis auditor liability has been diverse, the Eighth Company Law Directive on Statutory Audit did not deem it necessary to intervene. The Directive, designed to promote the Single Market principle by providing a uniform framework for the delivery of audit services, made no specific reference to auditors' responsibilities, nor did it define the circumstances under which auditors could be held liable. Member states were left to determine to an adequate degree, liability for a failure to act in an honest and independent manner.

Concerns about the EU Member States' divergent liability regimes came to the fore in the 1990s when the EC-commissioned study entitled "The role, position and liability of the statutory auditor within the European Union"¹²²⁵ concluded that the diversity was

¹²²² International Federation of Accountants (IFAC) (1995).

¹²²³ SAMSONOVA, A., Re-thinking auditor liability..., op. cit., p. 10.

¹²²⁴ Id.

¹²²⁵ BUIJINK, W., MAIJOR, ST., MEUWISSEN, R., & VAN WITTELOOSTUIJN, A., The Role, Position and Liability of the Statutory Auditor within the European Union, (1996), A Report by the Maastricht

likely to have an adverse effect on the development of auditing. Following the publication of the said study, the EC issued a Green Paper¹²²⁶ in the same year in order to foster further debate and consultation.¹²²⁷ The Paper stressed that the liability problem had become a principal issue facing the auditing profession. It highlighted differences in the statutory auditors' liability regimes across the EU as an impediment to the viability of the EU market. These conditions, it concluded, might lead to a greater audit market concentration. Although the paper acknowledged that 'the liability of the auditor should be limited to amounts which reflect his degree of negligence',¹²²⁸ it ultimately, suggested that the capacity for such action should rest with member states in the following words:

Action at EU level in this field is likely to be difficult. The audit profession is not the only profession which is struggling with problems of liability. Furthermore, the legal traditions in member states in the area of civil liability are quite different. It is for consideration whether the negative effects of a continuation of differences in the regulation of audit liability are significant enough to justify EU action, considering the difficulties which such action is likely to face and the possible discrimination which action specific to the audit profession might entail as regards other professions.¹²²⁹

Thereafter a conference involving the stakeholders coordinated at the EU level was held in December 1996. The conference brought together European audit regulatory community, academics, preparers as well as auditors.¹²³⁰ The opening note to the section of the conference on the issue of auditor liability stated the following:

We have saved probably the most difficult issue to the end of this Conference. Litigation against auditors is increasing. It is difficult to get an accurate picture

Accounting, Auditing & Information Management Research Center (MARC). Luxembourg: Office for Official Publications of the European Communities.
<<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/03/151&format=HTML&aged=0&language=EN&guiLanguage=en>

¹²²⁶ European Commission, (1996a). The role, the position and the liability of the statutory auditor within the European Union, Green Paper, Brussels: European Commission.

¹²²⁷ Green Paper at p. 9.

¹²²⁸ European Commission, 1996a, para.5.6.

¹²²⁹ European Commission, 1996a, para.5.7.

¹²³⁰ European Commission, 1996b.

of the extent of the problem because most cases are settled out of court. The situation is not the same in all member states. Rules on professional liability are not harmonized at EU level. The professional liability of auditors is dealt with differently at national level. There are systems of proportional liability, joint-and-several liability and indeed of limited liability. Is there a reason to limit the professional liability of the statutory auditor by law? Should this not be left to the parties concerned? To whom should the statutory auditor be held liable? Is there a reason for action at EU level? Is there a reason why the EU should take the initiative, as opposed to member states? Is it realistic to believe that one can deal with professional liability of auditors at EU level without at the same time tackling the liability regime of other professions? There is no doubt that we cannot give a final answer to this various questions today.¹²³¹

The conference was at a consensus in its conclusions that the EU legislative framework on auditing was in need of improvement which should derive from the IFAC's *International Standards on Auditing* (ISAs). On the possible EU action on auditors liability however, opinions varied. The audit industry and FEE voiced their support for liability limitation. Others on the hand expressed concerns that such limitation would cause inferior audit quality and shift liability to other parties. The relative scarcity of actual court cases against auditors was also cited as an indication that existing liability regimes were not as harsh as claimed.¹²³² Karel van HULLE, the then Head of the EC's Financial Information Unit, in his overview of the comments received on the Green Paper noted that:

The commentators from the accounting profession regret the absence of a clear message in the Green Paper that a limitation of liability should be organized at EU level. Most other respondents think that there is no justification for reducing the professional liability of auditors as opposed to other professionals. These commentators believe in particular that a liability cap is not in a public interest.¹²³³

¹²³¹ European Commission, 1996b, p. 193

¹²³² DARBYSHIRE, D. (1996) in SAMSONOVA, A., Re-thinking auditor liability..., op. cit., p. 11.

¹²³³ European Commission, 1996b, p. 30.

All this while, the EU's policy was based on a relatively 'non-invasive' strategy of coordination and collaborative encouragement of uniformity among member states to a more direct 'hands-on' approach to harmonization through legislative activity at the EU level. However, with respect to the issue of audit liability, the Commission continued to insist that liability limitation was unnecessary and considered auditor liability as a primary "driver for audit quality".¹²³⁴

However, a combination of factors that followed the demise of Enron in 2001, and the subsequent fall of Arthur Andersen together with a strong reaction from auditors themselves provoked a rethink on the part of the EU. The profession's forceful rhetoric following the collapse of Arthur Andersen, one of the Big Five audit firms then, resurrected earlier claims of 'cataclysmic' litigation and portrayals of auditors as ultimate victims of an unfair litigation battle that could potentially lead to another 'Big' firm failure with disastrous consequences for the longevity of the profession as a whole.¹²³⁵ These claims were further reinforced by an evidence of increased litigation in the post-Enron era helped to energize discussions around the importance of preventive regulatory policies¹²³⁶

Following intense lobby by advocates of liability reform especially the *European Contact Group* (ECG), i.e. a lobbying body set up in 1993 by the Big Four and medium-sized auditors BDO and Grant Thornton to generate a united front for the larger firms in Europe.¹²³⁷ Charles MCGREEVY, who succeeded Fritts BOLKESTEIN as a European Commissioner for Internal Market and Services in November 2004, took the bait together with Dutch MEP Bert DOORN. The two politicians contributed in a significant way to have the matter addressed by the European Parliament.

The outcome of these developments caused the launch, in November 2005, of European Forum on Auditors' Liability. The forum consisted of representatives of auditors, businesses, insurers, bankers, investors, among other interest groups. It was charged with the task of assessing potential solutions that would moderate auditors' litigation

¹²³⁴ SAMSONOVA, A., Re-thinking auditor liability..., op. cit., p. 13 quoting European Commission, 2003, para.3.10.

¹²³⁵ TALLEY, E. L., (2006) in SAMSONOVA, A., Re-thinking auditor liability..., op. cit., p. 13.

¹²³⁶ Id.

¹²³⁷ Id.

risk. Later on in 2006, the Commission duly appointed the consultancy firm London Economics to undertake this study. It has been widely argued that it was the outcomes of this research project that became a major catalyst for the subsequent change in European policy on audit liability.

The London Economics report came out in October 2006 with findings that the market for international audits was highly concentrated and effectively controlled by the ‘Big Four’ networks, which significantly reduced the likelihood of any middle-tier auditor becoming an alternative to the Big Four firms. It also found that audit market concentration has been aggravated by auditors’ inability to find insurance that will cover their total risk and thereby putting personal assets of partners at risk. It was, therefore, suggested that unlimited auditor liability combined with only limited availability of liability insurance left auditors unprotected against the ‘catastrophic’ consequences of growing litigation, increasing the likelihood of another large auditor’s failure, and even endangering the effective functioning of a broader economy.¹²³⁸ The report in this regard stated:

A failure of one of the Big-4 networks may result in a significant reduction in large company statutory audit capacity if partners and other senior staff at the failed firm, the remaining Big-3 firms, and possibly even some middle-tier firms, were to decide that auditing is a too risky activity and therefore shift to other business lines. This would obviously create very serious problems for companies whose financial statements need to be audited. In such circumstances, a major increase in the price of statutory audits would be required to restore the equilibrium between demand for and supply of statutory audit services.¹²³⁹

The publication of the London Economics’ report was soon followed by a public consultation on auditor liability launched by the European Commission in January 2007. The specific ideas that have been considered by the forum included:

1. A single monetary cap at EU level;
2. A cap based on the company’s size as a function of its market capitalization;

¹²³⁸ SAMSONOVA, A., *Re-thinking auditor liability...*, op. cit., p. 15.

¹²³⁹ London Economics (2006, p. 134).

3. A cap based on a multiple of the audit fees charged by the company; or
4. Limiting the contribution of the audit firm to the damages suffered by the plaintiff (proportionate liability), either by statute or contract.¹²⁴⁰

Charles MCGREEVY, an EU Internal Market Commissioner, praised the timeliness of these ideas: “there is a real danger of one of the Big Four being faced with a claim that could threaten its existence,” he said.¹²⁴¹ The European Commission established an “*Auditors Liability Forum*” to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commission issued a Staff Working Paper on “*Auditors Liability and Its Impact on the European Capital Markets*,” in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission’s Working Paper was largely based upon the study by *London Economics*.¹²⁴² In a January 2008 talk, MCGREEVY was quoted as saying that “I do not intend to impose the means by which liability is limited.”¹²⁴³

On June 5, 2008, European Commission came out with a proposal to limit liability awards against accounting firms where the civil claims arise out of audit work for listed companies. The recommendation, principally “aims to protect European capital markets by ensuring that audit firms remain available to carry out audits on companies listed in the EU.”

The EC explained its rationale as follows:

Liability reform is an international issue where member states should take action. It is in the public interest to ensure sustainable audit capacities and a competitive market for audit firms at international level. In the light of the current audit market structure, liability risks arising from the increasing

¹²⁴⁰ Directorate General for Internal Market and Services (2007a), Commission staff working paper: Consultation on auditors' liability and its impact on the European capital markets, Brussels: European Commission.

¹²⁴¹ EU Calls for Input on Auditor Liability Caps, (Compliance Week, Feb. 6, 2007).

¹²⁴² EU Call for Opinions on Auditor Liability Caps (Compliance Week, April 2007).

¹²⁴³ EU Commission to Offer Recommendations on Countries' Liability Caps for Audit Firms (BNA Corporate Accountability, Jan. 4, 2008).

litigation trend combined with insufficient insurance cover may deter auditors from providing audit services for listed companies. If these structural obstacles (liability risks/lack of insurance) persist, mid-tier audit firms are unlikely to become a major alternative to the “Big 4” audit networks on European capital markets. But there is also a risk of losing some of the existing players. One of the reasons might be that catastrophic claims cause the collapse of one of the major audit networks.

The EC believes that strengthening regulatory supervision diminishes the need for private litigation as a means of maintaining audit quality:

[A]udit regulators—not judges or courts—will in future play a pivotal role in maintaining the high audit quality which companies and investors deserve. In this regard, in addition to the requirements of the recent Directive on Statutory Audit, the Commission adopted on 6 May 2008 a Recommendation strengthening the robustness and independence of inspections of firms auditing listed companies. Such regular inspections provide better guarantees for the quality of the audits compared to unlimited civil liability rules which constrain access to this highly concentrated market. Audit quality should be driven more by sound regular inspections whilst liability should complement such efforts but not make the audit business unattractive.

The EC also noted there are practical limits on liability that are based on a firm’s ability to pay:

Even without any existing method of limiting liability, the expectations of third parties to obtain compensation face practical limits, corresponding to the financial capacities of the audit firms. In this respect, the advantage of limiting auditors' liability would be that the rules are fixed in advance and hence potential plaintiffs would not expect audit firms to be able to compensate them for unlimited amounts.

Among other details of the proposal, the limited liability scheme would not apply if there was intentional misconduct by an auditor. The EU is of the view that this proposal

would encourage new entrants into the field, especially for smaller audit firms and an optimal solution for improving the operation of the audit market as a result of increased fairness and predictability of auditors' risk exposure. Almost immediately, the European Commission's proposal was met with criticism from certain quarters, including the European lobbying group representing the insurance and reinsurance industries. And in August, 2008, the *International Corporate Governance Network* (ICGN) attacked the European Commission's efforts to allow EU member states to impose auditor liability limits, arguing that the proposal would favor auditors "to the detriment of other stakeholders and especially shareholders."¹²⁴⁴ These negative commentaries were countered by positive praise from other organizations, such as the *Federation of European Accountants* (FEA). All said and done, the recommendations represent a great feat by the audit firms with their campaign in the European regulatory arena than at individual member states level.

¹²⁴⁴ DICKY, J. C., Auditor Liability Caps..., op cit., p. 8.

FINAL CONCLUSIONS

I: Chapter I have served to provide a historical background to evolution of corporate government to its current standing. Former World Bank President, James WOLFENSOHN, once noted that “the proper governance of companies will become as crucial to the world as the proper governing of countries.”¹²⁴⁵ If this sounds like an exaggeration think of the desolation and the tidal wave of panic provoked across the globe by the recent financial crises! Even governments had been caught in a slumber. They woke up with their hands tied. In the sense that, they will either have to save these ailing companies or wait for the collapse of their country’s economy. Thus, some companies are so crucial to a country’s economy to the extent that they have a stranglehold on its government; hence leaving them to fail is never an option. This has been the experiences of both the United States and Spain. Both countries had to step in and rescue some banks and in case of the United States the auto industry as well, a move that saved the two economies from a brink collapse. At the centre of this malfeasance was the failure of corporate governance and the effective checks offered by audit. Moreover, a 2011 House of Lords Economic Affairs Committee investigation blamed the recent financial crisis on auditors’ dereliction of duty and called for the oligopoly of the four auditing firms to be broken. So now more than ever, the single largest concern for companies as well as governments is to reinforce transparency in corporate governance.

II: It has also been highlighted in this chapter that corporate governance and auditing serve two different functions, but they are by no means mutually exclusive. The two must reinforce each other if the ultimate aim of the corporate governance, of efficient application of company capital for the benefit of the shareholders, is to be achieved. To complement each other, however, does not give room for overlap of functions. Auditors by law and professional ethics are prohibited from any managerial functions, because whereas their term of reference is economic actions of the company, corporate governance covers a wide range of managerial functions. Moreover to preserve their independence and objectivity, they must not be mired into management decision table. Thus, the view that auditors should play a more direct role in bringing

¹²⁴⁵ Economist January 2 1999, p. 38.

about good corporate governance is stretching the string too far. On the alternative, the same objective can be achieved through a collaborative effort of directors being more responsive to auditors and making auditors feel more conscientious and therefore be more effective without the necessity of abandoning their term of reference. Accordingly, it is submitted that withholding of information to auditors by company directors in Spain should as well attract some legal consequence, apart from the penal code, like in the United States.

III: For easy comparison, the Spanish corporate law is discussed here as a component of the Single European Market. While it is true that the EU and the US had a different corporate constitutional history and admittedly their two models of corporate governance may have deep-rooted cultural and structural differences, they still share some significant commonalities. Both systems have deferred to its constituents members the right to regulate their internal affairs. Accordingly, corporate laws differences between the two models had led to what is commonly referred as ‘company law shopping’ where the competing states or member states as the case may be, are free to compete for company incorporation through their individual tax policies. In this same regard, goes the argument of the ECJ and the U.S. Supreme Court, where both courts emphasize that companies are creatures of the law and owe their existence to the sovereignty by which they are created. It follows, therefore, that the sovereign state is at liberty to determine their functioning. Notwithstanding this discretion, member states may not make laws to restrict free movement of goods, person, services and capital as assured under the EU treaty but may require companies to keep their head office at the place of their incorporation. Similar situation apply in the United States, where states are prohibited from interfering with Interstate Commerce Clause yet may enact laws to prohibit take-over of companies located in their States.

IV: Efficient market systems rely upon the availability of high quality and transparent information. Although Spain and the US have their own individual and unique systems of corporate governance reflecting different economic cultural and legal circumstances, they are both successful economies built upon a regulatory framework geared towards safeguarding their financial stability and investor interests. Apart from this safeguard, auditors are still employed to serve the private interests of the shareholders of a company. The financial audit remains an important aspect of corporate

governance that makes management accountable to shareholders for its stewardship of a company. That is why his or her role in the supervisory process requires standards such as independence, objectivity and integrity to be achieved. Auditors are not involved in the decision-making process of the company and therefore cannot be the primary causes of the recent financial crises. These are caused by bad lending and investing decisions, unwarranted risk-taking and perhaps some flaws in the credit-rating system. But the least required of auditing is that when companies make bad decisions that affect their standing, their report should properly disclose it.

V: There have been concerns even well before the financial crisis that proper attention was not given to regulation and the audit function as the audit expectation gap debate failed to challenge the presumed potential of the audit function. Instead of questions being asked about the audit practice, these have been ignored at the expense of the eagerness to bring out new rules for auditors to comply with. With the enactment of the Sox and the regulatory framework it established through the board, the traditional wisdom of self-regulation has been replaced with now largely accepted conviction that ‘auditing can be made to work in an appropriate fashion and can satisfy the demands of recipients of audit services – ‘if only’ a suitable form of audit regulation could be provided.’ As rightly observed by MITCHELL et al., “Consumers, shareholders, government and the public should not have to wait for scandals to float to the surface, posthumously, to know what is going on. Only proper accounting can tell them. Only proper audit can post the warnings.”¹²⁴⁶

VI: Even before the scandals that provoked the divorce from self-regulated framework to combined regulatory structure, some countries like Spain have shown a good promise in that direction. As noted by GARCÍA & HUMPHREY,¹²⁴⁷ while the emerging literature questioning the nature of audit practice has made a worthy start, there is a need for Anglo-Saxon ‘critical’ researchers to be less Anglo-centric in their analysis – to make more concerted efforts to recognize the diverse international contexts in which the auditing function is practiced, rather than presuming that discussions based in the context of an often unnamed British or American accounting profession have an unconditional international applicability. A reminder perhaps expressed more forcefully

¹²⁴⁶ Id. at p. 316 (quoting MITCHELL, A., ET AL., 1991)

¹²⁴⁷ Id. at p. 324.

in the shift by the US to a quasi-official regulatory structure, and in the Latin axiom, *audi alteram partem*, unless you hear other side, you cannot know the whole truth. Unsurprisingly, the EU has just embraced independent public oversight function as the most reliable system for enhancing audit quality and market security.¹²⁴⁸

VII: The concept of an audit expectation gap presupposes that the public's expectation of auditors duties is different from what auditors believe is their function. This has created an environment of suspicion between auditors and the public as well as increased the frequency of litigation against auditors. As seen above, the prevalence of the audit expectation gap is owed to a number of diverse factors like complicated nature of an audit function, self-regulation of the audit profession, the unreasonable nature of the expectation gap and the ambiguity of some auditing terms among others. Given the diversity of factors responsible for the expectation gap, the problem needs to be addressed from a number of different perspectives as well. One of such measures undertaken by regulators and professional bodies in Spain as well as the US to address the auditing expectations gap is the codification of auditing knowledge through the issuance of auditing standards. In the USA, for example, the profession attempted to narrow the gap by adopting the auditing standards of 1988. In the case of Spain, a similar effort was made with the adoption and publishing of the NTA-May/1993 auditing standard on the going concern assumption by ICAC. However, there is a growing sentiment within the academics that the development and eventual promulgation of an auditing standard is not more than an exercise of power by the audit profession to promote its own view regarding ethical behavior of its members over what the public may perceive. This can be seen in the US standard-setting procedure delicately designed to promote the interest of auditors rather than public interest.

VIII: This thesis can be sustained by the fact that the auditing standard had not affected auditors' behavior at the time of issuing a going concern opinion as evidenced in the above studies. Moreover, given the auditing profession's inability to at least forewarn on the pending bankruptcies that have supposed the financial scandals like Enron and WorldCom in the USA, the US Congress has concluded that the self-regulatory model had failed, and created a new regulatory model that mirrors that of

¹²⁴⁸ ADN, September 3 2010 at p. 8.

Spain. However, this change is not a guarantee. As evidenced in the above results, in Spain, where audit is state regulated, auditors' reaction to the auditing standards adopted has been the same as their American counterparts. Therefore stakeholders in the audit industry might wish to reflect more on the extent of state controlled regulation's ability to enhance audit function.

IX: We have presented here the application of the doctrine of pure economic in Spain as well as in the United States. Although the doctrine is not well covered in the United States, especially, in academics and scholarship as in Europe and other places, it still forms part of the country's judicial heritage. Historically common law has been applied across and beyond jurisdictions. In fact, judgments of common law jurisdictions, although not binding on other jurisdictions, are still cited as sources of persuasive influence. Moreover economic loss is of wide application in the American common law as seen in cases of product defects and auditor's liability. In Spain, on the other hand, the doctrine has just been introduced in reference to the coverage the doctrine is receiving in Europe. In fact, some principles of the doctrine have been incorporated into the Principles of European Tort Law, a soft law, which by design is now part of Spain's law. However, it is in academics that the doctrine is making important inroad in Spain, where terms like deep pockets, floodgate, and negligence as well as private and social loss are now a common place. Thus, even though liability in Spain is of general application without any restrictions whatsoever, the economic loss has become a useful tool for interpretation and understanding of tort law.

X: As illustrated here pure economic loss is a substantive as well as contentious area of law. Moreover, it is an area where increasing numbers of litigants seeking a remedy fall foul of a legal requirement not clearly defined. Whilst general principles have developed in many areas of tort, pure economic loss is one of those areas which have failed to produce a coherent and sustained set of rules. It is perhaps not surprising that the outcome of a particular case is dependent more upon the facts rather than an established principle. More often than not, the courts have offered differing views as to the reason for their decisions and thereby created more uncertainty. But given the importance of the tort of negligence and the magnitude of the pure economic loss question, it is perhaps surprising that there is still no agreement as to the basis upon which to restrict or allow recovery, and whether or not to hold a careless

defendant liable for harm. This, in a sense, should be expected given the complex and varied nature of economic loss cases in a fast changing economic and risk environments.

XI: In principle, pure economic loss may be recoverable on the basis that there is foreseeability, proximity and it is fair just and reasonable, or on the basis of voluntary assumption of responsibility. Yet in America, the traditional application of remoteness of damage or lack of duty seems to mask the real policy behind the pure economic loss rule, namely, a refusal to recognize liability without intelligible limits, which seems to be the common policy resonating in several of the cases. The simple explanation for this policy is perhaps the abhorrence of excessive and disproportionate punishment that Anglo-American tradition maintains. As such, even, the notion of proximate cause of harm in negligence law only serves to strike a balance of proportionality between a wrongful act and its consequent punishment. This has been the ever-present and continuing philosophy that has accompanied and sustained the pure economic loss rule since the celebrated *Ultramares*¹²⁴⁹ case.

XII: It is my contention that the argument behind the reluctance by the courts to extend exclusionary or economic rule for the fear of disproportionate liability is consistent with logic and common sense. As observed by RABIN, “it would make no sense to hold a careless driver responsible for the massive pure economic losses suffered when he brings traffic to a standstill in the Brooklyn Battery Tunnel during the rush hour. Although the harm he causes might properly be regarded as a cost of driving, it is not the kind of loss that is sufficiently predictable in magnitude to make preventive measures feasible. The type of catastrophic loss that involves an exceedingly low risk of an extremely high magnitude of harm is generally a very poor candidate for deterrence through tort liability.”¹²⁵⁰

XIII: Arguably, in a competitive economic society the conduct of one person is always liable to have economic consequences for another. The golden rule is one man’s loss is another’s gain. As TOULSON J posited “every day countless people suffer pure

¹²⁴⁹ [1931] 255 NY 170

¹²⁵⁰ RABIN, R. L., “Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment”, *Stanford Law Review*, 37, 1985, p. 1538.

economic loss of one kind or another through acts or omissions of others, and to seek to apportion blame and redistribute such losses would involve massively cumbersome and expensive legal machinery. However, the courts have departed from that general approach in certain cases where such a special relationship exists between the injured party and the party who has caused the injury...that to refuse recovery would seem a denial of justice.”¹²⁵¹

XIV: Perhaps, the most instructive view on the policy reasoning behind whether a person is liable to another is found in the dictum of DENNING MR in the case *Lamb v. Camden LBC*¹²⁵², where his Lordship laid bare the judicial policy and expounded that “the truth is that all these three – duty, remoteness and causation – are all devices by which the courts limit the range of liability for negligence or nuisance. As I said recently ‘...it is not every consequence of a wrongful act which is the subject of compensation. The law has to draw a line somewhere’. Sometimes it is done by limiting the range of the persons to whom duty is owed. Sometimes it is done by saying that there is a break in the chain of causation. At other times it is done by saying that the consequence is too remote to be a head of damage. All these devices are useful in their way. But ultimately it is a question of policy for the judges to decide.”¹²⁵³

XV: In the end, it is to the law of tort’s credit that it was able to use the instrument provided by the common law to implement and adapt to any challenges that the changes of cultural and economic shifts may assign to it. It is logical and healthy to debate the propriety or otherwise of the economic loss rule, but it is undeniable that over the course of time, the courts have found the means to extend the scope of the law in response to a changing socio-economic context. The economic loss rule is understandable in the context of natural evolution of the law to address a social need at a given time and place, like substitution of comparative negligence for contributory negligence.

XVI: Thus, even the economic rule is evolving with time as seen in cases of consequential loss and liability for negligent statements, like the case auditor. In all

¹²⁵¹ *Lee v. Taunton & Somerset NHS Trust* [2001] 1 FLR419 at 422

¹²⁵² (1981) QB 625

¹²⁵³ *Id* at p. 636.

these cases the courts have demonstrated the necessary pragmatism required in expanding the long arm of the law in resolving a pressing need. “Tort law often expands as a means of deterring undesirable behavior and as a means of providing compensation to victims. However, the scope of tort law can sometimes be restricted when public policy concerns concentrate on the unfavorable results of unlimited liability.”¹²⁵⁴ I concur!

XVII: The array of doctrines and their various interpretations suggest that, despite the expansion of grounds for liability, economic loss caused by words was still viewed with particular suspicion. In addition to finding an adequate approach to evaluate the existence of a duty of care, the courts also had to ensure that, once this duty was found, its scope would be adequately controlled. The United States’ common law courts presented with an auditor liability case are faced with problems of choice among array of doctrines as well as how to apply their preferred doctrine when selected. This process involves more than simple application of law to facts. The doctrines are imprecise and not so clearly defined that they can hardly be applied without considerably more thought by the courts. As is evident in the auditor liability cases, doctrine does not dictate which rule or which interpretation of an adopted rule is authoritative. Instead, the controlling doctrine is, in the first instance, prescribed by and then interpreted through policy analysis.

XVIII: The variations in application of the Restatement test make this point more clearly. The same doctrinal formulation that is applied to require the functional equivalent of a third-party beneficiary relationship by the California court in *Bily*,¹²⁵⁵ approaches a broad negligence standard grounded in foreseeability when applied by the North Carolina court in *Raritan I*.¹²⁵⁶ The importance of policy factors in the analysis of liability considerations ultimately depends on the courts’ assessment of the demands of society about the desirability of a rule or outcome in terms of the social values of utility, right, morality, or legal institutional values such as judicial competence and administration.¹²⁵⁷

¹²⁵⁴ BAKER, C. R. & PRENTICE, D., *Origins of Auditor Liability...*, op cit, p. 179.

¹²⁵⁵ 834 P.2d 745 (Cal. 1992)

¹²⁵⁶ 367 S.E.2d at p. 609.

¹²⁵⁷ See KENNEDY, D., “A Critique of Adjudication” (Fin de Siecle), 1997, p. 99.

XIX: The threat of imposing open-ended liability on a defendant has been one of the central policy factor concerns of courts in accountant liability cases since the beginning, receiving its authoritative expression in *Ultramares*.¹²⁵⁸ In that case, CARDOZO argued that liability for negligence “may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.”¹²⁵⁹ The threat of indeterminate liability is particularly acute in accountant liability cases because the consequences of a negligent audit report can extend very far, unlike the consequences of a negligent act causing physical injury.¹²⁶⁰ The consequences of a physical accident can be catastrophic, but they tend to be limited in space and time to the immediate victims.¹²⁶¹ The economic consequences of a negligent audit, on the other hand, can extend along chains of causation to many persons far removed in time and contact from the accountant.¹²⁶²

XX: Once an audit report is issued, it can be disseminated widely and relied on by members of the general public. The rippling of consequences is particularly likely to occur today since information can be passed quickly and costless from person to person (and often many persons at once) in ways over which the accountant has no control.¹²⁶³ As brilliantly adumbrated by Judge Cardozo “liability for negligence if adjudged in this case will extend to many callings other than an auditor’s. Lawyers who certify their opinion as to the validity of municipal or corporate bonds, with knowledge that the opinion will be brought to the notice of the public, will become liable to the investors.... Title companies insuring titles to a tract of land... will become liable to purchasers who may wish the benefit of a policy without payment of a premium.”¹²⁶⁴

XXI: However, the main policy factor, which has preoccupied the United States’ common law courts, is the fear of opening the floodgates of litigation. On the one hand, such factors as the fear that an open-ended liability might seriously injure the

¹²⁵⁸ 174 N.E. 441, 444 (N.Y. 1931)

¹²⁵⁹ *Id.*

¹²⁶⁰ SILICIANO, J. A., *Negligent Accounting...*, op. cit., p. 1943.

¹²⁶¹ Economic loss which flows to persons other than the immediate victim of the accident, such as the emotional harm suffered by members of the victim’s family, do raise indeterminacy problems and are usually dealt with under special duty rules.

¹²⁶² *Id.*

¹²⁶³ FEINMAN, J. M., *Liability of Accountants...*, op. cit., p. 57.

¹²⁶⁴ *Ultramares*, 255 N.Y. at 188.

profession or burden social and commercial life have also been assessed. On the other hand, these arguments have been balanced against, *inter alia*, the need to deter negligent conduct and to furnish incentives to caution, as well as the fact that auditors are in a better position to protect themselves by getting insurance and passing on its costs to their clients.

XXII: We have discussed here that in Spain as well, auditors' work may lead to liability under both contract and tort law. Auditor liability in Spain is found under the Civil Code and company law as well as the audit law. Compensation under this system is, however, not for pure financial loss but under the general principles of liability enshrined under Civil Code. While liability for contract is *ipso facto* without controversy, liability to third parties has been controversial both in its essence and its reach. The figure of third party (*tercero*) is well recognized under Spanish law. Moreover it is clearly stated under the audit law that auditors are liable not only to their clients but to third parties, like investors and creditors, who suffered loss as result of their audit. Moreover, investors as consumers are entitled to the protection of the law

XXIII: Notwithstanding this provision, some legal experts like PANTALEÓN do not believe that the third party referred to both under the Civil Code and the audit law is of unlimited application. The learned author argued that both the audit law and the civil code refer to third parties within the contemplation of the auditor and his client company at the time of entering into audit contract, someone to whom the audit report is submitted or someone directly induced by the auditor. PANTALEÓN further argues that subjecting an auditor or auditing firm to potentially massive liability would be tantamount to violating their constitutional rights enshrined under articles 38 and 53 of the Spanish Constitution. According to PANTALEÓN, auditors cannot be liable to the world at large or be made the insurers of their clients by default.

XXIV: The above arguments by Mr. PANTALEÓN were answered by none other than the Spanish supreme court in cases "SSTS, 1ª, núm. 798/2008, de 9 de octubre, 869/2008, de 14 octubre, 115/2009, de 5 marzo and 355/2009 de 27 mayo", where the court held that auditor's report is a document made not only for the audited company but also for the purpose of exhibiting it to third parties, and has been so recognized by Spanish law. Accordingly the law has required that the said document be deposited at

the mercantile registry. When so deposited it becomes a public document at the disposal of all. Therefore, under Spanish law auditors are liable to third parties under the general principles of liability with no limitation or restriction. This does not in any way mean a *carte blanche* for the claimant. The claimant must show the damage suffered and also establish a causal relationship between the damage and the fault of the auditor. Then the court will look at the circumstances of the case to determine whether the claimant has been diligent at the time of relying on the audit. The court will then evaluate the circumstances of the case and come to a judicial conclusion on whether the claimant's case should succeed.

XXV: It must be noted, however, that this liability does not make the auditor a bloodhound. The auditor is not required by law to substitute the managers or correct all their errors or irregularities; he or she is only required to comply with professional standards and obligations. Once that is done the auditor is absolved from liability. The auditor may only be judged in accordance with the standard of his or her peers.

XXVI: This analysis shows that the common law system of the US used its various interpretations of the duty concept in keeping audit liability within a reasonable limit, while the civil law of Spain achieved that through the flexible use of the concept of causation. "But since we all live in the same social and economic environment, and since the judicial function can, [I believe], be epitomized as an educated reflex to facts, find that, in civil law countries as in common law countries, not only are we beset with the same practical problems, but broadly speaking we reach the same practical solutions. Our legal concepts may be different, and may cause us sometimes to diverge; but we have much to learn from each other in our common efforts to achieve practical justice founded upon legal principle."¹²⁶⁵

XXVII: Chapter IV has highlighted the birth and growth of audit accounting over the years into an indispensable player in the financial market. While it is true that the beginning of the 21st century has been marked by corporate and accounting scandals, and these scandals, can exact a terrible toll in terms of human suffering (e.g., unemployment and lost retirement savings)." They had also served as an opportunity to

¹²⁶⁵ (1987) 2 WLR 480 (HI.) at 511.

inquire into their causes with a view to prevent their occurrence in the future, at least on a similar scale. As noted earlier, the most important corporate reforms historically had come about as a result of financial scandals. But unlike the antecedent reforms, the recent reforms are more comprehensive and far reaching. In covering the same ground, the SOX and the 8th Directive represented the convergence of audit oversight on a global scale. The SOX, for example, has made dramatic changes to some of the fundamental institutions that define auditing in the US, like the transformation of the self-regulated accounting industry into a semi-governmental agency called the Public Company Accounting Oversight Board.

XVIII: The EU on the other hand, apart from the Ahold and Parmalat scandals, had to grapple with other pending reasons that played significant role in the modernization of the 8th Directive. First, in Europe there was a necessity to adjust the EU regulatory framework to the demands of an increasingly globalised audit practice. Secondly, the EU even before the onset of the crisis has been in the process of harmonizing the European audit market, the crisis only made it more urgent. In the end, the European Union and the U.S. took a different path in their response to the corporate scandals and their respective efforts to improve corporate governance and restore public and investor confidence to the financial sector. The European Union chose a mix path of binding directives together with non-binding recommendations. The US, on the other hand took a heavy regulation through the SOX.

XXIX: Apart from its positive transformation of audit practice and corporate governance, SOX has been widely criticized for centralization of corporate governance in the United States. This approach of varied company law practice across the United States gave companies the opportunity “forum shopping” to choose a state best suited for their interest. The same scenario is playing out in the European where the issue is centralized corporate legislation is sensitive to the constituting member states that jealously guard their national identities and peculiarities. On this issue, the European Commission has made it clear that when a federal legislation become necessary by way of directives, the directives should be based on general principles, leaving member states to fill in the details in accordance with their peculiarities and needs. The practice of subsidiarity has worked with great success in the European Union, especially, in the

area of corporate governance, where member states are given the flexibility of adapting the directives over a period of time.

XXX: With regards to financial statements responsibility, the EU chose to place a collective responsibility on the board. The US, on the other hand, puts the emphasis on the executives and officers of the company. In addition, while the US has made the responsibilities of the audit committee a matter of federal law, the European Union stops at issuing a non-binding recommendation. The EU also has its peculiar problem and need to tackle the recurring problem of audit expectation gap which seems to be widening by the day. The combined effect of all these concerns was the issuance of Statutory Audit Directive of 2006. In the end it is only hoped that the combined and broad reach of the SOX and the 8th Directive will provides the necessary safeguard in ensuring that audits are carried out in an atmosphere of integrity, objectivity and independence. However, it must be understood that both efforts are work in progress because a perfect corporate regulation does not exist in human institutions.

XXXI: The consistent and continued global campaign by the important audit firms has succeeded in making the issue of liability reform a subject of judicial and legislative inquiries internationally. Generally, the campaign has achieved considerable success but auditors think it is insufficient. Several countries have taken measures over the years to limit auditor liability in some form. This can be seen in the case of the US, where the Private Securities Litigation Reform Act of (PSLRA) was enacted in 1995 and later in 1998 the related Securities Litigation Uniform Standards Act (SLUSA). Both laws have to some extent altered the liability of audit firms from joint-and-several to proportional liability in an effort to curb meritless claims by “deep pockets” plaintiffs against audit firms. Some European countries, on the other hand have chosen to place cap on the limit of audit firms liability exposure, and most importantly, member states of the European have just completed adapting their laws to the European Commission recommendation that European Union member states should take measures to limit auditor liability.

XXXII: Conceivably, given the initial attitude of European Commission of not tampering with the liability regimes of member states, the caps recommendation, marks a dramatic turnaround. But if one thinks that the audit profession has finally nailed a

victory. Then it worth pondering on the approach adopted by the Commission, according to SAMSONOVA, “as opposed to a blanket law approach, the Commission opted for a softer country-to-country option solution giving discretion to individual nations in terms of selecting a suitable limitation method. This is effectively an indication that the EU has refrained from fully addressing the very complexity of the liability debate evident in the national differences of liability regimes across Europe.” Therefore, although a milestone, it is by no means the end of the road for the proponents of liability reform.

XXXIII: In the US tide for liability reform is also gathering pace as the support for reform continue to grow, albeit with political fears from the public that is yet recover from the aftershock of the Enron and WorldCom debacle. There seem to be the feeling in the US that now is not the appropriate time to temper with the status quo. In fact, there are voices in the Democratic Party, like Senator Elizabeth Warren of Massachusetts, who argue that those responsible for the financial crisis should be held accountable. Meanwhile, it is feared that decreasing liability may decrease the incentive auditors have to do thorough and accurate work, once the potential cost of their mistake is lessened or removed. Apart from that, auditor liability threat is also a necessary regulatory tool used by the SEC to increase accuracy and investor confidence. Investor confidence is the foundation of any financial market and auditor liability helps to strengthen it. Given the devastating effect the recent crisis had on investor and public confidence, the US capital markets cannot afford any more crisis of confidence that liability cap may generate.

XXXIV: Finally, if eventually the US decides to follow the lead of Europe in capping auditors’ liability, it is hoped that such reform would be sensitive to investors’ needs and look at policies that best serve their interests as well as generate confidence in the market. The reforms must also take cognizance of the fact that auditors play the role of engendering confidence of investors in the capital markets, and this confidence should not be taken for granted. In light of a recalcitrant global financial crisis, and the continued effects it has on the U.S., and on the global capital markets as a whole, it is vital that any reform adventure should be geared towards promoting investor confidence an economic recovery that is still fragile.

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